The financial sector in a state of flux – Changes to the business model of European banks as a major focus for European supervisory authorities

Sven Hansen
DZ BANK, Frankfurt am Main, Germany
Slovenskej poľnohospodárskej univerzity v Nitre, Nitre, Slovakia
sven-christian.hansen@t-online.de

Abstract. On 19 December 2014, the European Banking Authority (EBA) published its finalised guidelines on the supervisory review and evaluation process (SREP) as per art. 97 CRD IV. (European Commission, 2013, CRD IV) These guidelines have in part already been incorporated into the European Central Bank’s (ECB) guidelines on banking supervision and are therefore of outstanding importance for future banking supervisory practice. The responsible authorities have to incorporate these guidelines into their supervisory work from 1 January 2016 onwards.

Keywords: financial sector, bank, business model of bank, supervisory authorities

Introduction

The SREP guidelines (European Banking Authority, 2014) provide a comprehensive system consisting of the various components. First of all, in keeping with the idea of proportionality, banks are subdivided into four categories, whereby the institutes most important from the viewpoint of supervision come under the first category. The categorisation is based on size, structure and internal organisation as well as the type, scope and complexity of a bank's business activities and is intended to reflect the risk the bank in question has for the financial system as a whole. What is new here is that the supervisory bodies also focus on analysing the banks' business models.

Depending on how they are categorised, banks are then subject to different minimum levels of supervision, which corresponds in principle to the previous philosophy of "banking supervision risk profiles" pursued by the German Bundesbank. In practical terms, this also has an influence on the rhythm of the supervision of certain key indicators, the evaluation of various core areas, and the regular supervisory dialogue. The assessments focus in particular on internal governance and controls, the key risks, and the adequacy of equity and liquidity levels.

Each individual component is rated in terms of a scoring system. These individual results are then summarised to comprise the SREP overall assessment. The figures for each score run from “1” (no discernible risk) to “4” (high risk). The Guidelines include corresponding scoring tables as a yardstick for each element stated. The SREP overall assessment may also culminate in the category “F” as per art. 32 BRRD (European Commission, 2014, BRRD). The EBA intends this to link up ongoing supervision and crisis management (early intervention and macro-prudential measures). The score values must be suitable to provide an indication of the banks’
viability and the need for supervisory or early intervention measures. Depending on the score a bank achieves, the relevant authorities can then demand, amongst other things, increases in capital coverage or additional liquidity buffers.

Precisely this assessment process is now embedded in many regulatory requirements that banks must heed. In the discussion below the focus will initially be on the assessment process and on how it may potentially influence a bank’s business model. This outline will be followed by a description of other regulatory areas that accompany the search for a profitable business model.

Business model analysis in SREP

The business model analysis (BMA) supports the other elements of the SREP. It addresses business and strategic risks and serves to analyse the sustainability and viability of a bank’s business model.

To this end, in the EBA’s opinion supervisory agencies should not only analyse the current business model, but also rate the forward-looking strategy and financial plans, and identify any weaknesses. To this end, the supervisors should rely on a substantial number of the bank’s internal information sources (strategic planning, recovery and resolution plans, supervisory and internal reporting) and also draw on external sources (stability reports, rating reports).

The over-arching objectives of the BMA are to establish a bank’s (Heithecker, H., 2015, page 8):

- viability: sufficient earnings for the coming 12 months;
- sustainability: sufficient earnings for the coming 36 months;
- potential to fail: identification of key vulnerabilities.

The BMA assessment process is built around several core elements. First of all, the analysis identifies the areas of focus to be addressed and evaluates the bank’s business lines and environment. This is followed by a quantitative and qualitative analysis of the environment and an assessment of the bank’s forward-looking strategy and financial plans. All these studies then provide a score that is used to classify the bank in question.
To identify the key areas of focus for the BMA, the analysis needs address not only the relevant banks' business lines, but also their materiality as regards profits, risk and importance to strategy. To enable the supervisory body to evaluate this, a peer group is defined in order to provide a point of comparison for key ratios and analyses.

After this initial assessment, the business environment is analysed with a view to rating the influence of important external factors. This analysis of the business environment rests primarily on macro-economic factors, such as GDP, unemployment rates, interest rates, etc.

However, the qualitative and quantitative analysis of the business model proper goes to make up the backbone of the BMA. The idea is to identify the factors driving a bank’s success, pinpoint what these depend on, and understand the degree to which a bank’s results depend on its risk appetite. The quantitative values thus reached are then juxtaposed to the figures for the peer group and those of other banks under EU supervision (EBA-Risk-Dashboard).

Key quantitative financial figures for the BMA (Heithecker, H., 2015:14):
- profit and loss account: income streams and costs, impairments, net interest, CIR;
- balance sheet: structure of assets/ liabilities, funding structure, RoE, Tier-1;
- ICAAP/ILAAP: TREA, shortfall in refinancing;
- concentration risks in the balance sheet and profit and loss account: clients, sectors and geographies.

Key qualitative dependencies (Heithecker, H., 2015, page 16):
- external dependencies: third parties, sales intermediaries, regulatory drivers;
- internal drivers: IT platforms, human resources, economies of scale;
- business processes: clients, partners, product positioning, importance of reputation, competitive advantages over the peer group.

Alongside these status analyses, the BMA also includes forward-looking analyses. The idea behind these analyses of the strategy and financial plan is to rate them in terms of plausibility, risk and assumptions made. This way the assumptions made
sufficiently take account of macroeconomic trends, market trends, key products’ volumes and margins.

The current status and the forward-looking plans are evaluated in terms of economic viability, sustainability and possible vulnerabilities. To this end, key figures such as earnings power, concentrations, risks and external factors are considered in order to compare the bank’s funding structure and risk appetite with the peer group. The objective: to evaluate whether in light of the business model sufficient profits can be earned (12 and 36 month horizon). Moreover, the impact of possible vulnerabilities is likewise assessed.

At this stage of the outline one should inquire critically whether supervisory authorities can in fact determine whether profit is sufficiently defined and whether drawing on a peer group is always meaningful. For example, owing to the national specifics, some banks can hardly be classified in terms of a peer group. In particular a peer group cannot do justice to the different roles and business form of savings banks and cooperative banks in the various European countries.

Moreover, information asymmetries exist between the supervisory authority and the bank. This can, as economic theory tells us, give rise to the principal-agent problem and the issue of moral hazard.

**Business model Canvas and SREP-BMA**

The Business Model Canvas has evolved as a standard for visualising a business model and start-up idea and for testing whether it makes entrepreneurial sense. It was developed by Alexander Osterwalder and published in his book “Business Model Generation” (Osterwalder, A., Pigneur, Y., Smith, A., 2010). The SREP-BMA includes the key blocks contained in the Business Model Canvas. The “Analysis of the current business model” and the “Analysis of the strategy and financial plans” provide an examination of key partners and key resources. The business model analysis likewise includes an appraisal of the respective bank’s client segments. The discussion of “income sources” and “cost structure” in the Business Model Canvas is essentially a cross function and is thus included in almost every step of the SREP-BMA. While the SREP BMA does not explicitly mention the other client-related success drivers (value offered, channels, customer relationships, key activities), in some places the SREP-BMA does actually go beyond the blocks covered by the Business Model Canvas. For example, the peer-group comparison, the analysis of risks and vulnerabilities, and a forward-looking business environment analysis are all elements of the SREP BMA that could be referenced as key additional components for a BMA as regards a supervisory assessment of banks (Heithecker, H., 2015, page 50).
**Excursus: Income streams as a component of the BMA.**

The central component of any BMA is how the model seeks to generate income in the future. In order to secure specific earnings power going forward, when identifying a suitable business model first and foremost it is the following questions on earnings risk which need to be answered:

![Figure 3: Canvas and the SREP-BMA](image)

**Figure 4: Income and BMA**

<table>
<thead>
<tr>
<th>Income as an integral element of the BMA</th>
<th>Instrument</th>
</tr>
</thead>
<tbody>
<tr>
<td>Which are the profit driver?</td>
<td>Descriptive analysis</td>
</tr>
<tr>
<td>- geographic scope, business fields, products</td>
<td></td>
</tr>
<tr>
<td>Which trends have an impact on the profit?</td>
<td>Stress tests</td>
</tr>
<tr>
<td>- technic, demographic, regulations</td>
<td></td>
</tr>
<tr>
<td>How does the annual profit develop?</td>
<td>Descriptive analysis</td>
</tr>
<tr>
<td>- interest surplus, Cost-income-ratio</td>
<td></td>
</tr>
<tr>
<td>Are there any profit-concentrations?</td>
<td>Descriptive analysis and stress tests</td>
</tr>
<tr>
<td>- customers, industry sectors, geographic</td>
<td></td>
</tr>
<tr>
<td>Are there any external drivers?</td>
<td>Stress tests</td>
</tr>
<tr>
<td>- third party providers, broker</td>
<td></td>
</tr>
</tbody>
</table>
Theory vs. legal supervisory standards

Alongside the stipulations given for the SREP there are of course scholarly research studies on which the BMA discussion has focussed. Various authors have, for example, offered specific core statements on the business model used by a particular bank. Thus, studies address the structure of the bank’s balance sheet and income streams as well as its legal form. Moreover, the composition of income from operating activities and total liabilities, driven by the business model, allows us to draw conclusions as to the respective bank’s stability. The studies thus discuss issues such as whether retail banks do indeed bear a lower risk (Ayadi, R., De Groen, W.-P., 2014) and whether the earnings power of banks refinanced through deposits business is greater than that of banks that finance themselves through the interbank market (Roengpitya, R., Tarashev, N., Tsatsaronis, K., 2014). Precisely the increasing academic debate on these matters also prompted the European supervisory authorities to concern themselves with business models. The goal of the studies is by relying on the academic and supervisory statements to identify a business model for banks that should, given its risk structure, enable the banks to survive possible future crises.

The debate about which banking activities can be considered impervious to crisis is also to be felt in the current discussion at the European level on separating investment from debt banking. The desired separation of debt banks and investment banks impacts direct on bank business models. Precisely given this topical context, the distinction bears examining a little more closely and the study by AYADI / GROEN (Ayadi, R., De Groen, W.-P., 2014) linked to the statements by the EBA. In its paper “Overview of the potential implications of regulatory measures for banks’ business models” (European Banking Authority, 2015) the EBA examines the various bank business models and compares these to the different regulatory requirements.

AYADI / GROEN discern four different business models in the banking industry. They thus distinguish not only between investment banks and debt banks, but also sub-divide debt banks into three different categories. The EBA paper revolves around a similar sub-division. Instead of differentiating as regards retail banking, in the EBA paper investment banking is subjected to a more differentiated view. AYADI / GROEN conclude that retail banks bear less risk and are least in danger of failing. Even if their efficiency and profitability are not always comparable with those of other business models.

The EBA published a forward-looking paper as a foil to this descriptive account. The paper examines the future influence of regulatory measures on these bank business models.
### Figure 5: EBA vs. AYADI / GROEN

<table>
<thead>
<tr>
<th>European bank business models</th>
<th>EBA (potential implications of individual regulatory measures)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Ownership</strong></td>
<td><strong>(Financial) activities</strong></td>
</tr>
</tbody>
</table>

Business model components are like to be:
- discouraged (decreasing effect): -
- encouraged (increasing effect): +
- not effected =
- affected inconclusively +/-

by the implementation on the new rules

Thus, the EBA (2015) comments on the capital requirements:
Banks will move to business lines that require less capital. Retail banking will not be particularly affected and nor will long-term corporate loans and long-term asset-based finance businesses (commercial real estate, project finance for instance). Other products with relatively higher risk weights such as unsecured loans, and trade finance business will see a decline in volumes. Investment banking and trading businesses will be significantly affected due to the higher risk weights with fewer securitisations, lower trading book exposures and reduced activities in areas such as derivatives, repos and securities financing. It is possible that by
reducing the trading book, banks might then increase the loan supply and make a profit out of retail business. An increase in loan supply would also lead to higher consumption and economic growth. (Page 15)

What is interesting about this study is that the regulation clearly affect precisely retail banking in many regards. Moreover, this is the case although many (empirical) studies have shown that exactly these business models tend to entail low risk and are relatively impervious to crisis.

Thus, the EBA (2015) comments on the leverage ratio requirements:

Since the LR is a non-risk-weighted measure, it would especially affect banks whose business model involves low-margin and low-risk but high-volume lending (e.g. certain types of mortgage lending and municipal finance). For those banks, the LR might become the de-facto limiting factor, although regulatory capital ratios would leave room for further lending. These banks might face challenges to generate sufficient earnings, if for a given amount of business a price adjustment is not possible, hence might be forced to alter their business model. This might involve changing the asset structure towards riskier assets to generate higher margins. Banks might thus shift their exposure from government financing or retail banking activities with high amounts of mortgage lending towards corporate banking, trading book and other non-traditional banking activities (though the final effects on retail may only be ascertained once the adjustments have taken place). Furthermore, evidence suggests that investment banking activities might be reduced if some divisions use a lower average risk weight compared to other business areas. As off-balance-sheet exposures are included in the calculation of the LR, they might fall, while the effect for private banking activities is inconclusive due to the different business elements of which they comprise. (Page 18)

The EBA (2015) believes retail and corporate banking will also be influenced by the future liquidity requirements:

All European banks will be subject to these rules. High-quality liquid assets (HQLA) will be required to meet the LCR requirement. Banks may find that large HQLA holdings, with correspondingly low RWAs may mean that the LR (rather than the capital ratio) becomes a binding constraint. As retail assets are not considered HQLA, a bank facing problems satisfying the LCR may exit retail assets in favour of HQLA; alternatively they may package retail assets in a covered bond or securitise through RMBS, but in both cases there will be frictional costs due to over collateralisation. [...] Investment banks may face the tension of holding enough HQLA in order to both be able to satisfy LCR and post collateral for margin calls should the need arise. LCRs of mortgage banks, building societies, CCPs, securities trading house and custodian institutions are relatively high. Despite a strong HQLA portfolio, private banks are penalised by a significant short-term liquidity gap. The adjustment required looks critical for auto banks, consumer credit banks and
pass-through financing banks as they hardly hold any HQLA. Nevertheless, proprietary trading and market making activities may potentially benefit due to government and corporate bonds being held in these business lines. Banks that take deposits (retail and universal banks, and possibly private banks) will find it easier to satisfy NSFR as they have a retail deposit base; conversely, banks that are particularly dependent on wholesale funding (such as investment banks) may find it challenging to meet NSFR, other things (including asset structure) being equal. A cost-effective strategy is to reduce assets requiring funding, or concentrate on high-quality, short term loan/bond assets, and have long-term debt and/or equity. [...] As NSFR excludes short term wholesale funding, the latter cannot be used for satisfying the ratio (an issue for investment banks, who are more reliant on this funding type). Off-balance-sheet exposures are taken into account for ratios, and therefore there is little incentive for entering into these transactions from a liquidity point of view. (Page 22)

In particular against the backdrop of the European debate on separating debt from investment banking, it bears pointing here to the statements the EBA has made on the individual components of the business model. For example, the EBA says that capital requirements do not influence the “banking model”. However, the EBA does identify at precisely this point an influence on retail, corporate and investment banking that reflect a “specialised banking structure”. The paper does not, however, reveal how this contradiction can be resolved.

Other distinctions within the business model are to be discerned in the following matrix the EBA gives and in the afore-mentioned scholarly studies.

Figure 6. Implications for business models

<table>
<thead>
<tr>
<th>Banking model</th>
<th>Operative structure / Governance</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Universal banking structure</td>
<td>• Number of branches</td>
</tr>
<tr>
<td>• Specialised banking structure</td>
<td>• Intergroup flows</td>
</tr>
<tr>
<td></td>
<td>• Importance of internal governance</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Activities</th>
<th>Geographic scope</th>
<th>Risk appetite and performance</th>
<th>Liquidity</th>
<th>Structure of income</th>
<th>Originate to hold / distribute</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Retail Banking</td>
<td>• Domestic and non domestic assets and liabilities</td>
<td>• RWA / total exposure</td>
<td>• Capital</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Corporate Banking</td>
<td></td>
<td>• RoE</td>
<td>• Deposits</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Investment banking</td>
<td></td>
<td>• Loan to deposit ratio</td>
<td>• Wholesale funding</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Private Banking</td>
<td></td>
<td>• Costs</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Non-banking activities (insurance)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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Conclusion

The discussion above shows that not only academic research has focused on bank business models, as the bank watchdogs are increasingly doing the same. While the issue of “business models” has played a role for some time now in the academic discussion, it would appear that only in recent years have the supervisory authorities started to focus on it. This is shown by the SREP assessment process discussed above, where the business model clearly plays a key role. That said, the business model is anchored in the supervisory review process not only at the European level. National regulations increasingly also extend to include the business model (see MaRisk in Germany).

The discussion on whether to influence banks’ business models directly as was sparked at the European level by the LIIKANEN report (Liikanen, E., 2012) compares with the individual regulations issued by the European supervisory authorities (e.g., Basel III, CRR/CRD IV). In general, the objective pursued at the European level is to stabilise the banking sector and install a crisis-proof financial system at the European level. The intention is to make certain that a financial crisis such as followed on from the LEHMAN bankruptcy would second time round no longer have such a severe impact on private investors and government budgets.

The regulations issued by the individual supervisory authorities (EBA, ECB, Basel) are, however, differentiated to such an extent that their effect is in part at loggerheads with other efforts. This can be seen from the influence exerted by LIIKANEN on the universal banking structure, on the one hand, and the resulting debate and impact of individual regulatory measures. Thus, firstly an attempt is made to distinguish between banks in terms of their business models and, secondly, precisely these specialist bank structures are subject to stricter regulation by the supervisors.

Precisely this situation makes it difficult for the individual banks to find a business model which is also profitable. The sheer number of regulations coupled with the supervisory reviews is prompting the financial industry to seek a business model specifically in line with these determinants that does justice to all sides, the supervisory authorities and the shareholders and stakeholders. Much would indicate that specialist banks in the retail segment and in part in the corporate sector fulfil exactly these requirements. It remains doubtful whether they would then survive another financial crisis. Such an assumption flies in the face of the empirical fact that in the past the non-specialist universal banking system has been less susceptible to being affected by the crises than has the specialised banking structure in England or the United States.
References


