Supervisory practices for assessing the sustainability of banks' business models[1]

Executive summary

Pre-existing and structural vulnerabilities related to unsustainable business models are often the root causes of bank failures. The impairment of a bank's solvency and/or of its liquidity are generally consequences of deeper and far-reaching problems, with their origins frequently lying in poorly conceived and unrealistic business plans and/or the inadequate execution of such plans. The most frequent causes of bank failure include switching from a low-risk business model to a high-risk one, and pursuing rapid growth without developing the appropriate risk culture and risk control environment and functions. Accordingly, and drawing on the lessons from the Great Financial Crisis (GFC), supervisors have become more proactive, more willing to exercise their powers and more inclined to systematically assess the sustainability of banks' business models.

Business model analysis (BMA) is a key component of supervisory frameworks in many jurisdictions that allows supervisors to identify banks' vulnerabilities at an early stage and helps to ensure safety and soundness. This includes assessing the implications of banks' strategic decisions and their consistency with their risk appetite. It also includes determining whether and to what extent the business strategy is adequately resourced, funded and executed. Where the outcomes of the analysis identify existing or potential vulnerabilities, the assessment may provide grounds for supervisory interventions. Therefore, BMA has the potential to enhance bank supervision and make it more effective, proactive and forward-looking.

BMAs have both micro and macro implications. From a microprudential perspective, BMAs are an important part of a more comprehensive assessment of a firm. By identifying the root causes of a bank's weaknesses, BMA's findings may support supervisory actions aimed at ensuring that the board and senior management adjust the business strategy and implement it in a sustainable way. The purpose is to put the bank "back on track" before it becomes a weak bank and breaches regulatory requirements. From a macroprudential perspective, BMA outcomes may inform system-wide policy decisions seeking to address structural problems, such as overcapacity, limited or a lack of profitability, systemic risk concentrations and risks to financial stability more generally.

Comprehensive BMA frameworks typically share common ingredients. These include understanding how a bank generates profits and therefore identifying its sources of income and expenses, and their respective levels as well as assessing whether sources of income are recurrent, well-diversified and stable over time. Additional components include reviewing the bank's growth strategy in its various markets and assessing whether the resources allocated to the implementation of this strategy are adequate.

An effective assessment considers all relevant developments in the business and economic environments in which the bank operates. At present, forward-looking assessments would, in principle, need to consider banks' ability to adapt their business models in light of the end of the long period of low interest rates in a number of jurisdictions, as well as the increasing use of novel technologies in the provision of financial services and competition from new players, such as big tech firms. Also critical but

[1] Rodrigo Coelho (Rodrigo.Coelho@bis.org), Amélie Monteil (Amelie.Monteil@bis.org), Vasily Pozdyshev (Vasily.Pozdyshev@bis.org) and Jean-Philippe Svoronos (Jean-Philippe.Svoronos@bis.org), Bank for International Settlements.

The authors are grateful to Raihan Zamil for helpful comments. We are also grateful to Marie-Christine Drexler and Esther Künzi for valuable support with this paper.

even more challenging, a comprehensive BMA would need to take into account the potential impacts of climate change and the banks' ability to identify, manage and mitigate their exposures to climate-related financial risks, including both physical and transition risks.

Granular and good-quality data, adequate data aggregation capabilities and expert judgment are indispensable elements of an effective BMA framework. Such a framework is predicated on banks' ability to produce and aggregate financial data across the banking group as a whole and for each of its main business units and business lines. Some of these may reflect recent information on performances and profitability, from which an assessment is derived about the firm's ability to adequately compensate stakeholders while also sustaining its future development in a balanced way. Others may be more forward-looking and reflect a bank's ability to adapt to – and even take advantage of – changes. In both cases, the information needs to combine quantitative and qualitative assessments.

Processes and procedures related to BMA also share common elements across jurisdictions. The frequency and sophistication of BMAs reflect the level of complexity and systemic relevance of the supervised entities. The most complex tools involving stress tests, profitability forecasts and scenario analyses are generally used for the larger and more systemically important entities and groups. Some tools, such as peer group comparisons, tend to be used in various guises across jurisdictions including for smaller and less complex firms, mainly as a first step to identify outliers. Therefore, by applying the principle of proportionality, BMA can contribute to improving the supervision of banks with different profiles.

Authorities organise BMAs in different ways within their supervisory framework and this has implications for their ability to take actions on the basis of BMA findings. One of the main differences is how business risk is captured and analysed. Some jurisdictions consider it as a separate component of their supervisory review process (SRP) and assess it at bank-wide or group level. Others prefer to assess it for each individual business line along with assessments related to the governance and the risk management of the specific activity. While each type of approach has merits, having business risk as a standalone component of the SRP seems to be more conducive to early supervisory intervention as it provides a more direct association between deficiencies in banks' business models and the implications for their safety and soundness.

A constructive and ongoing dialogue between the supervisory authority and the supervised entity is a pre-condition for an effective BMA. Such an interaction allows the supervisory authority to discuss and, whenever needed, to challenge the bank's strategy and its underlying assumptions and to convince the bank's board and senior management through moral suasion to address deficiencies before they become material and start damaging the bank's performances. In addition, in the course of such a dialogue, BMA's findings are presented and explained to the supervised entity. This practice promotes transparency and accountability.

Clear and transparent supervisory expectations support early intervention when a bank's business model is deemed to be unsustainable. When prudential or operational requirements have been breached, and such breaches have been duly identified, supervisory interventions are mandatory. Supervisory interventions may become more difficult when a bank remains fully compliant with all regulations and risk management standards. In these circumstances, taking pre-emptive actions on the grounds that a business model may become unsustainable at some point in the future is more challenging. Accordingly, clarity and transparency about supervisory expectations in relation to the characteristics of a sustainable business model is a key component of a BMA framework that supports supervisors when they need to take measures at an early stage to prevent deficiencies from becoming material.