A Business Model Approach to Measure Risks

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Abstract

Enterprise risk managers should explicitly relate the firm's business model to the risk supported by the economic capital. The economic capital, risk drivers and business model are intricately integrated. The purpose of this paper is to demonstrate this point. This business model approach has many applications. For example, in order to ensure the safety and soundness of the U.S. banking system, federal bank regulators must be able to effectively monitor the underlying risks of banking institutions. This requires that the risks be assessed from the perspective of the business models used by banking institutions.

This paper presents a model of thrift's business model, and examines the model empirically using the extensive portfolio data on institutions supervised by the Office of Thrift Supervision (OTS). The paper studies the economic values of assets and liabilities on thrifts' balance sheets for the end of September 2006 and shows that the business models used by the thrifts are defined by their leverage and portfolio mix of mortgages and deposit fundings. The result shows that if the business model is not taken into consideration, the adequacy of the capital may be mis-specified. This paper further examines the characteristics of nine peer groups of similar business models and shows how they can be used to control for the variations of business models in the measurement of risks. These results have broad implications on enterprise risk management for financial institutions in general, not only specific to the thrifts.

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