



# **Critical Functions: SRB Approach**





## Critical Functions: SRB Approach in 2017 and Next Steps

**Keywords:** critical functions, SRB, SRM

**Background:** This document serves as a reference to describe the approach taken by the SRB to the identification of critical functions.

**Disclaimer:** The SRB policy on critical functions is subject to further revisions, including due to changes in the applicable European Union (EU) legislation. This public document aims at making the public in general, and institutions in particular aware of the SRB policy on critical functions as well as the process followed by the SRB as from the 2017 resolution planning cycle. The SRB policy on critical functions represents a common approach to ensure consistency and level playing field within the Banking Union, and it takes into account where necessary any bank-specific features. The SRB may deviate from the content of this document if it considers it necessary and in the line with bank-specific features and the applicable legislative framework.

## EXECUTIVE SUMMARY

### *Context*

- 1 The identification of critical functions is a key element of the resolution planning activity, since it has consequences for many aspects of resolution plans.
- 2 First, the presence of critical functions is one of the criteria to consider when performing the Public Interest Assessment (PIA), in which Resolution Authorities (RAs) assess whether normal insolvency proceedings would or would not achieve the desired outcome to the same extent as resolution action. This paper focuses on critical functions only and a separate document on the approach followed by the SRB on the PIA will be published later this year.
- 3 Second, the identification of critical functions is relevant for the selection of the preferred resolution strategy, which should be designed to maintain critical functions through resolution. Key elements of that strategy, such as the separability analysis and the determination of loss-absorbing capacity, should preserve the institution's critical functions and take into account the internal and external services, systems and infrastructure necessary for the provision of such functions.
- 4 Critical functions are defined in Article 2(1)(35) of Directive 2014/59/EU (the Bank Recovery and Resolution Directive, [BRRD<sup>1</sup>](#)) as "activities, services or operations the discontinuance of which is likely in one or more Member States, to lead to the disruption of services that are essential to the real economy or to disrupt financial stability due to the size, market share, external and internal interconnectedness, complexity or cross-border activities of an institution or group, with particular regard to the substitutability of those activities, services or operations".
- 5 Critical functions hence play an important role in the real economy and/or in the financial system. They are not only important for the institutions providing the services, but also for the broader economy of a particular region or Member State (MS). This distinguishes such functions from critical services, which are the "underlying operations, activities and services performed for one (dedicated services) or more business units or legal entities (shared services) within the group which are needed to provide one or more critical functions".<sup>2</sup>
- 6 For the 2017 resolution planning cycle, the SRB developed – in close collaboration with NRAs and with the participation of the ECB and the EBA – a common approach for Banking Union (BU) headquartered significant and cross-border less significant institutions to guide them when assessing the criticality of their functions. This approach, which is in line with the EU regulatory framework (BRRD, Regulation (EU) 806/2014 (SRMR<sup>3</sup>), Commission

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<sup>1</sup> <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32014L0059>

<sup>2</sup> Recital 8 of Commission Delegated Regulation 2016/778,  
<http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1523961324800&uri=CELEX:32016R0778>

<sup>3</sup> <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32014R0806>

Delegated Regulation (DR) 2016/778) and the FSB Guidance on the Identification of Critical Functions and Critical Shared Services (2013), also includes policy guidance and tools to support IRTs in making the final call on whether a function should be considered critical or not.

### *SRB approach*

- 7 In the European Union (EU), institutions are required to self-assess critical functions when drawing-up their recovery plans (“bottom-up approach”). This self-assessment is also reported to and reviewed by RAs (“top-down approach”), with a view to achieving an appropriate and consistent identification of critical functions.<sup>4</sup> The conclusions of this review feed into the resolution plan.
- 8 The Single Resolution Mechanism (SRM) developed a common approach to enhance consistency in the identification of critical functions in resolution plans. The approach consists of a standardised template (i.e. the Critical Functions Template) with a common set of indicators and assessment fields, and associated guidance for institutions (these two documents are published on the SRB’s website), complemented by policy guidance for use within the SRM.
- 9 The Critical Functions Template specifies five economic functions, as identified by the FSB, for which an assessment needs to be undertaken: 1) deposits, 2) lending, 3) payment, cash, settlement, clearing and custody (PCSCC) services, 4) capital markets and 5) wholesale funding. The Critical Functions Template breaks these five functions down further into sub-functions to better inform the SRB’s analysis.
- 10 The SRB assesses the criticality of each economic function, based on reported data, comparisons with peers and expert judgement, taking into account available institution-specific and market-wide information. In 2017, the SRB collected data from all institutions under its remit, at individual legal entity or at (sub-) consolidated level, depending on the structure of the banking group. The SRB also developed a benchmarking tool to enable internal resolution teams (IRTs)<sup>5</sup> to compare the reported data by country and by function. In 2018, the SRB is collecting data at country level, aggregating all the activities of entities within that country. In addition, Critical Functions Reports<sup>6</sup> continue to be required at the level of the EU ultimate parent undertaking as well as at sub-consolidated and individual level, as appropriate.

### *Steps in the criticality assessment*

- 11 Whether a function is considered critical or not rests on an assessment of impact and substitutability. DR 2016/778 specifies that RAs should assess the impact on third parties

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<sup>4</sup> EBA/Op/2015/05, Technical advice on the delegated acts on critical functions and core business lines.

<sup>5</sup> IRTs are responsible for preparing resolution plans for banks under the SRB’s remit. They consist of experts from the SRB as well as relevant NRAs.

<sup>6</sup> Banks fill the Critical Functions Template. Once the template is filled and reported, it becomes the Critical Functions Report.

of the disruption in the activity and the degree of substitutability of the function in the market where it is provided.

- 12 When assessing the impact, the SRB makes the following assumptions, among others:
- The critical functions analysis should focus on the impact (on the real economy and/or on financial stability) of a sudden disruption of a *specific function* (e.g. lending to SMEs) and not of *the whole bank*.
  - For deposits, the value on covered deposits and the Deposit Guarantee Scheme (DGS) are not considered relevant.
  - For lending, determining the impact of potential new lending is more important than the current stock of outstanding loans.
  - For capital markets, the SRB mostly focuses on the role of institutions as liquidity providers to the market at national and/or EU level. In the same vein, when assessing wholesale funding, the SRB considers the importance of institutions for the smooth functioning of interbank funding markets.
- 13 In the supply-side or substitutability analysis, the SRB aims to ensure similar outcomes across institutions operating in the same market. This consistency is pursued through benchmarking of individual responses from institutions.

### *Geographical level*

- 14 The SRB considers the national level as the “relevant market” by default. Nevertheless, it also allows for assessing the impact at a different geographical level (regional/EU/global) in the rare cases in which the default option is not considered appropriate.
- 15 Ultimately, the SRB assesses the impact of the disruption at the national level. Without such impact, it cannot be concluded that a function would be critical at the level of “one MS or higher”, in line with the BRRD.

### *Next steps*

- 16 The critical functions analysis is an ongoing process, which also depends on complete and accurate data obtained from institutions. The methodology behind the identification of critical functions will be refined over time in light of experience. The SRB intends to continue enhancing its guidance for institutions, as published on its website. The SRB will also further develop the tools for benchmarking the institutions’ self-assessments and IRT’s conclusions, to ensure a high degree of consistency in the BU as well as the understanding of specific markets.
- 17 Furthermore, the Critical Functions Template and data collection process will be aligned with the new EBA ITS on resolution reporting. The EBA is in the process of updating the ITS on the provision of information for resolution plans (Commission Implementing Regulation (EU) 2016/1066<sup>7</sup>), commonly referred to as the “EBA templates”. The SRB will

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<sup>7</sup> <http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1523961169589&uri=CELEX:32016R1066>



(slightly) adjust its template and guidance accordingly to make sure that the EBA and SRB templates are fully compatible.

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## ABBREVIATIONS

BCBS	Basel Committee on Banking Supervision
BRRD	Bank Recovery and Resolution Directive
BU	Banking Union
DGS	Deposit-Guarantee Scheme
DR	Commission Delegated Regulation, 2016/778 if not further specified
EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
EU	European Union
FOLTF	Failing Or Likely To Fail
FMI	Financial Market Infrastructures
FSB	Financial Stability Board
G-SIB	Global Systemically Important Bank (FSB)
G-SII	Global Systemically Important Institution (EU)
IRT	Internal Resolution Team
ITS	Implementing Technical Standards
KA	FSB Key Attributes
MFI	Monetary Financial Institution
MREL	Minimum Requirement for Own Funds and Eligible Liabilities
MS	Member States
NPLs	Non-Performing Loans
NPMS	Non-Participating Member States
NRA	National Resolution Authority
PCSCC	Payment, Cash, Settlement, Clearing and Custody services
PIA	Public Interest Assessment
RA	Resolution Authority
SME	Small and Medium-sized Enterprise
SRB	Single Resolution Board
SRM	Single Resolution Mechanism
SRMR	Single Resolution Mechanism Regulation



## INTRODUCTION

- 18 **Resolution regimes have been designed, *inter alia*, to ensure the continuity of institutions' critical functions when institutions cannot be liquidated under normal insolvency proceedings without significant negative spillover effects on financial stability or on the real economy.** This is also the case of the BRRD, which sets five resolution objectives, one of which is "to ensure the continuity of critical functions". Such regimes endowed RAs with powers and tools enabling them to effectively achieve the resolution objectives, for example by determining adequate levels of loss-absorbing capacity or defining perimeters on which relevant resolution tools may be applied without impacting critical functions.

**Box 1: Five resolution objectives**

- ✓ Ensure the continuity of critical functions;
- ✓ Avoid significant adverse effects on financial stability, in particular by preventing contagion, including to market infrastructure, and by maintaining market discipline;
- ✓ Protect public funds by minimising reliance on extraordinary public financial support;
- ✓ Protect depositors covered by Directive 2014/49/EU<sup>8</sup> and investors covered by Directive 97/9/EC<sup>9</sup>;
- ✓ Protect client funds and client assets.

- 19 **Critical functions are functions that are essential for the smooth running of the economy in one or several Member States.** These are "activities, services or operations the discontinuance of which is likely in one or more Member States, to lead to the disruption of services that are essential to the real economy or to disrupt financial stability due to the size, market share, external and internal interconnectedness, complexity or cross-border activities of an institution or group, with particular regard to the substitutability of those activities, services or operations".<sup>10</sup>
- 20 **To be considered critical, a function needs to fulfil both of the following:**
- (a) "the function is provided by an institution to third parties not affiliated to the institution or group; and
  - (b) a sudden disruption would likely have a material negative impact on the third parties, give rise to contagion or undermine the general confidence of market participants due to the systemic relevance of the function for the third parties and the systemic relevance of the institution or group in providing the function".<sup>11</sup>

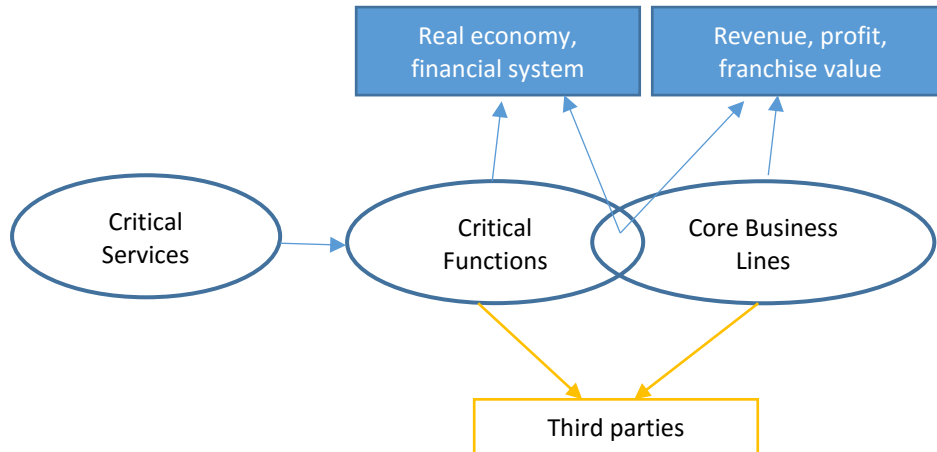
<sup>8</sup> Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes, <http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1523960222755&uri=CELEX:32014L0049>

<sup>9</sup> Directive 97/9/EC of the European Parliament and of the Council of 3 March 1997 on investor-compensation schemes, <http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1523960319806&uri=CELEX:31997L0009>

<sup>10</sup> Article 2(1)(35) BRRD.

<sup>11</sup> Article 6 of Commission Delegated Regulation 2016/778.

Figure 1: Critical functions vs. critical shared services and core business lines



- 21 **Critical functions differ from critical services and core business lines, even though they are intrinsically linked.** In contrast to critical services, which are “the underlying operations, activities and services performed for one (dedicated services) or more business units or legal entities (shared services) within the group which are needed to provide one or more critical functions”<sup>12</sup>, critical functions are always provided to third parties, external to the institution and even to the banking group. Whilst this is also true for core business lines, these differ from critical functions as they are material sources of revenue, profit or franchise value for the bank, while critical functions play an important role in the real economy or in the financial system (figure 1). Institutions are required to map critical functions to legal entities and core business lines in annex III of the EU resolution reporting templates (the “EBA templates”).<sup>13</sup>
- 22 **The responsibility of RAs to ensure the continuity of critical functions makes critical functions an essential element in resolution plans.** Critical functions are identified and described in the Strategic Business Analysis section, the introductory, descriptive part of resolution plans.<sup>14</sup> Subsequent chapters in resolution plans focus, inter alia, on ensuring the continuity of the identified critical functions in resolution. To that end, resolution plans identify which internal and external services, systems and infrastructure are necessary for the provision of critical functions.
- 23 **The critical functions analysis feeds into the separability analysis and in the determination of available loss-absorbing capacity,** both of which have direct consequences for the preferred resolution strategy (see figure 2):
- RAs need to identify organisational units providing critical functions and assess whether such functions can be separated from the rest of the institution and, if yes, which costs and difficulties this would entail. This is of particular importance if the resolution plan

<sup>12</sup> Commission Delegated Regulation (EU) 2016/778.

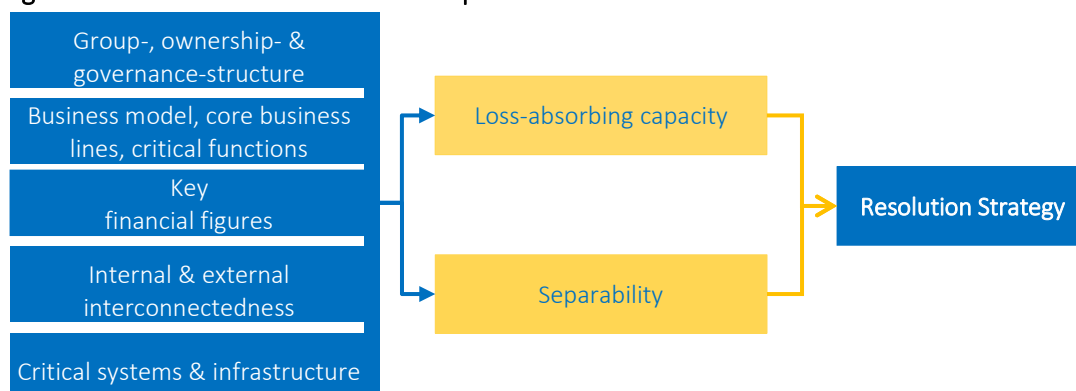
<sup>13</sup> Commission Implementing Regulation (EU) 2016/1066.

<sup>14</sup> For information on the content and structure of resolution plans, please refer to the [Introduction to resolution planning](#).

foresees the creation of a bridge institution, but it could also be meaningful for other resolution tools, as well as for the business reorganisation plan;

- RAs need to identify the liabilities whose exclusion would be strictly necessary and proportionate to achieve the continuity of critical functions in a manner that would maintain the ability of the institution to continue key operations, services and transactions.

Figure 2: Critical functions in resolution plans



- 24 **An appropriate identification of critical functions supports effective decision-making following a determination of failing or likely to fail (FOLTF).** The presence of critical functions plays a key role in determining whether a bank will be wound up under normal insolvency proceedings or whether resolution action will be applied if it fails. Resolution action is only applied if it is considered to be in the public interest, i.e. if it is necessary for the achievement of, and proportionate to, one or more of the resolution objectives, and normal insolvency proceedings would not meet those resolution objectives to the same extent.
- 25 **Regulatory guidance provides an adequate framework for the identification of critical functions across the EU.** The methodology proposed by DR 2016/778 foresees a two-step approach, comprising:
- **an impact analysis** to assess the impact of the sudden disruption of the function on third parties, as well as the systemic relevance of the function for third parties and the systemic relevance of the institution or group providing the function, taking into account the size, market share, external and internal interconnectedness, complexity and cross-border activities of the institution; and
  - **a substitutability analysis** to assess whether the market can replace this function in an acceptable manner and within a reasonable timeframe.
- 26 **To ensure consistent implementation of the framework within the BU, the SRB has developed – in close collaboration with the NRAs and with the participation of the ECB and the EBA - a common approach in 2017 for the identification of critical functions.** This approach is based on a standardised template with a common set of indicators and assessment fields, and associated guidance for institutions. It



operationalises the above-mentioned DR to a large extent, without setting thresholds and without weighting the different criteria used in the determination of criticality. However, at this stage, the limited experience of RAs in the identification of criticality and the fragmentation of the European banking landscape hamper further quantitative harmonisation.

## SRB APPROACH TO CRITICAL FUNCTIONS

### A- PROCESS AND TIMELINE

- 27 **The first element of the common approach within the BU is the “bank package” which consists of the Critical Functions Template and associated guidance.** It was first presented publicly at the industry dialogue event held on 30 January 2017, which provided the industry with the opportunity to ask questions and share experiences with regard to the identification of critical functions. It was also posted, the same day, on the website of the SRB. The high-level results of the SRB’s analysis of 2017 critical functions reports were presented at the industry dialogue on 16 November 2017.
- 28 **The second element of the common approach is the internal policy guidance prepared for the first time for IRTs in advance of the 2017 resolution planning cycle.** This guidance supports IRTs in reviewing the institutions’ self-assessments, taking into account, among others, the importance of the institution in providing the function, as well as the presence of competitors and their ability to take over the function within a reasonable timeframe. This high-level policy guidance is outlined in the next section of this paper.
- 29 **Institutions have performed a first self-assessment of critical functions using the Critical Functions Template in 2017.** The self-assessment was sent to the NRA of the group’s parent entity by 28 April 2017. It was subsequently reviewed by the SRB and the relevant NRAs and discussed with the institutions. The SRB has also benchmarked institutions’ reports across banks and MS, which provided additional information about the credibility of institutions’ self-assessments. This allowed IRTs to decide on the assessment of criticality for entities related to institutions under the SRB’s remit and reflect these decisions in the 2017 resolution plans.
- 30 **In 2018, institutions self-assess their critical functions again using the Critical Functions Template.** The deadline for the self-assessment has been set at 30 April 2018. The reporting process has not changed compared to 2017.

Figure 3: Identifying critical functions – overview of the timeline



## B- SRB APPROACH TO CRITICAL FUNCTIONS

### Scope

- 31 **RAs need to have a good understanding of which entities provide critical functions within a banking group.** This is necessary for identifying the point of entry of resolution and determining which entities belong to the resolution group<sup>15</sup> in the planning phase, enabling RAs to best achieve the resolution objectives. This can be illustrated by mapping functions to individual entities (cf. figure 4).
- 32 **In 2017, the SRB required Critical Functions Reports at individual or (sub-consolidated) levels.** The critical functions analysis was carried out for the majority of institutions within the SRB's remit. All legal entities (and, in some cases, branches) that were found to perform critical functions in 2016 were requested to report. In addition, IRTs requested Critical Functions Reports from other entities, including third-country entities, where this was deemed necessary to the preparation of the resolution plan. In certain cases, (sub-) consolidation was allowed or required. In particular, an aggregated view at the national level was considered necessary, where it was assumed that the market would consider all the entities of a banking group as a single risk. Branches of institutions incorporated in the EU were also required to report individually where such branches were considered to be important to the local economy of the host Member State.
- 33 **In 2018, banking groups were in most cases required to report the Critical Functions Templates at country level, aggregating all the activities of entities**

<sup>15</sup> See [Proposal for a Directive amending Directive 2014/59/EU](#) for a definition of resolution group.

**within each Member State.** In addition, the SRB often required consolidated reports at the level of the ultimate EU parent undertaking, to obtain an overview of the critical functions performed by the group, irrespectively of the entities performing such functions. Sub-consolidated reports were required in some cases where different sub-groups (e.g. operating under different brands and/or different business models) exist in one country. More granular information at the individual level was also often deemed necessary, in particular for entities that were found to perform critical functions in 2017.

- 34 **No institution was exempted from reporting requirements based on the preferred resolution strategy, even for open bank bail-in strategies.** The resolution strategy, including the determination of the resolution perimeter, follows from, amongst others, the identification of critical functions. The strategy may vary over time if the structure and activities (and criticality for third parties) of the institution vary. Moreover, RAs need to understand which functions should be preserved in the reorganisation period and how to ensure winding-down or a sale would proceed smoothly. They also need to know which liabilities are necessary to perform critical functions when assessing the potential consequences of liquidation under normal insolvency proceedings, write down and conversion or bail-in.

Figure 4: Mapping of critical functions to entities

			Name entity 1	Name entity 2	Name entity 3	Name entity 4	Name entity 5
Deposits	F.1	Households					
	F.2	Non-financial corporations - SMEs					
	F.3	Non-financial corporations - non-SMEs					
	F.4	General Governments					
Lending	F.11	Households - lending for house purchase					
	F.12	Households - other lending					
	F.13	Non-financial corporations - SMEs					
	F.14	Non-financial corporations - non-SMEs					
	F.15	General Governments					
Payment, Cash, Settlement, Clearing, Custody	F.21	Payment services to MFIs					
	F.22	Payment services to non-MFIs					
	F.23	Cash services					
	F.24	Securities settlement services					
	F.25	CCP clearing services					
	F.26	Custody services					
Capital Markets	F.31	Derivatives held for trading - OTC					
	F.32	Derivatives held for trading - non-OTC					
	F.34	Secondary markets / trading (held-for-trading only)					
	F.35	Primary Markets / underwriting					
Wholesale Funding	F.41	Borrowing					
	F.42	Derivatives (assets)					
	F.43	Lending					
	F.44	Derivatives (liabilities)					

### *Relevant economic functions*

- 35 **The SRB has built upon the five relevant economic functions identified by the FSB.** These functions are: deposit-taking; lending; PCSCC; wholesale funding,<sup>16</sup> and capital market activities. The SRB further divided these into sub-functions to better inform its analyses. This breakdown was based on FSB methodology, further refined in the light of current practice at NRAs. A standardised assessment level and pre-defined functions allow cross-country comparisons and foster a consistent approach across the BU.
- 36 **No economic function was considered critical *ex ante* (i.e. before appropriate analysis).** The determination of criticality depends on the particular institution and market circumstances at hand. For example, it would not be justified to always consider deposit taking as critical; criticality is not credible when market shares are low and substitution can be achieved rapidly and effectively.<sup>17</sup>

### *Informed judgment*

- 37 **The approach combines standardisation and flexibility.** The approach imposes a common structure, while allowing the responses to be tailored to the particular institutional or market circumstances. For example, the Critical Functions Template contains pre-defined sub-functions; it nevertheless allows institutions or authorities to report and analyse additional functions.
- 38 **Ultimately, the criticality assessment in resolution plans is a matter of judgment by RAs, built upon both qualitative and quantitative information.** The data and assessment steps included in the Critical Functions Template do not lead to an automatic conclusion. The approach combines quantitative and qualitative assessments and is designed to inform expert judgment within IRTs.

### *Critical functions, financial stability, public interest, resolution strategy*

- 39 **The analysis of the presence of critical functions informs part of PIA.** It is, *a priori*, more likely that there will be a *public interest* in resolving an entity or banking group that provides critical functions. Nevertheless, the assessment of critical functions is only one of the aspects to consider when performing the PIA. Ultimately, RAs need to ascertain that normal insolvency proceedings would not achieve the resolution objectives to the same extent as resolution action.
- 40 **The SRB aims to distinguish financial stability impacts resulting from a disruption to individual economic functions from the overall consequences of failure.** Ensuring the continuity of critical functions and avoiding significant adverse effects on financial stability are separate resolution objectives. The critical functions analysis aims to identify banking functions which unexpected unavailability *individually* would lead to the

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<sup>16</sup> Wholesale activities refer to lending and borrowing in wholesale markets to and from financial counterparties.

<sup>17</sup> FSB, Guidance on Identification of Critical Functions, July 2013, Annex 2, Deposit taking, drivers of criticality.



disruption of services that are essential to the real economy or would disrupt financial stability. In contrast, the financial stability analysis focuses on the impacts of failure of the entire bank, including the wider consequences of the institution's inability to fulfil its obligations towards clients or counterparties.

- 41 **The presence of critical functions is also one of the relevant criteria for the selection of the preferred resolution strategy.** RAs design the key elements of that strategy, which combines appropriate resolution tools and actions, with a view to preserving the institution's critical functions through resolution.

## C- STEPS IN THE CRITICAL FUNCTIONS ASSESSMENT

- 42 **In line with DR 2016/778, criticality is assessed in two steps.** First, the impact on third parties of the disruption in the activity must be assessed. The higher the impact, the higher the likelihood that the function will be considered as critical. Then institutions and RAs must determine the degree of substitutability of the function in the market in which it is provided. The greater the ease with which the function can be obtained from alternative providers, the lower the likelihood it will be considered critical.

### *Impact analysis*

- 43 **The SRB uses a set of indicators in line with the requirements of the DR** (box 2). These include two size related indicators (e.g. to take into account both the number of clients and the value of accounts), one cross-border indicator (to assess whether severe impact may be felt across borders) and a market share indicator. Institutions provide a score for each indicator, depending on the reported quantitative data and expert judgement. IRTs compare individual entity reports to peers and to overall market sizes. They also verify if institutions' own assessments of size or market share are consistent with their overall assessment of impact.
- 44 **For deposits, the DGS is not considered relevant to determine impact.** The value of deposits covered by the DGS is not taken into account in the analysis, as the DGS is not considered to replace the institution in providing the function. The DGS itself does not remedy a disruption in the provision of the function. Therefore, the existence and strength of the DGS itself play no role in the determination as to whether the relevant institution needs to continue providing deposit-taking services to its clients.
- 45 **The SRB does not, a priori, differentiate between different types of deposits.** The deposit-taking function is considered to consist in the institution's ability to receive and store monetary value for its customers. Therefore, time deposits or savings accounts are not distinguished from current accounts as the value on such deposits may usually be withdrawn after the payment of a penalty. Furthermore, the transactional dimension of current accounts is specifically captured by the payments function.

**Box 2: Assessing the impact on third parties**

According to the Commission Delegated Regulation<sup>18</sup>, the assessment of impact on third parties shall include the following elements:

- ✓ “the nature and reach of the activity, the global, national or regional reach, volume and number of transactions; the number of customers and counterparties; the number of customers for which the institution is the only or principal banking partner;
- ✓ the relevance of the institution, on a local, regional, national or European level, as appropriate for the market concerned. The relevance of the institution may be assessed on the basis of the market share, the interconnectedness, the complexity and cross- border activities;
- ✓ the nature of the customers and stakeholders affected by the function, such as but not limited to retail customers, corporate customers, interbank customers, central clearing houses and public entities;
- ✓ the potential disruption of the function on markets, infrastructure, customers and public services. In particular, the assessment may include the effect on the liquidity of markets concerned, the impact and extent of disruption to customer business, and short-term liquidity needs; the perceptibility to counterparties, customers and the public; the capacity and speed of customer reaction; the relevance to the functioning of other markets; the effect on the liquidity, operations, structure of another market; the effect on other counterparties related to the main customers and the interrelation of the function with other services.”

- 46 **For lending, determining the impact of potential new lending is more important than the current stock of outstanding loans.** Institutions are thus asked, in their judgment of impact, to take expected future lending flows into account, including existing credit facilities which have already been committed to clients, but have not yet been (fully) utilised.
- 47 **The SRB also uses other sources to complement its assessment of impacts.** One such source is the FMI report, also submitted by institutions. For example, the information it contains on the role of institutions as indirect access providers to FMIs allows the SRB to confirm the assessment of criticality for the sub-function “Payment services provided to MFIs”.
- 48 **When assessing whether capital market activities are critical, the SRB mainly focuses on the role of institutions as liquidity providers to financial markets.** In that respect, institutions support trading and price discovery in secondary markets and allow access to capital markets to firms in primary markets, thereby facilitating appropriate funding of economic activities.
- 49 **When assessing whether wholesale funding is a critical function, the SRB considers the importance of institutions in the interbank funding market.** Interbank funding markets play a key role in optimally allocating resources within the economy. Past financial crises have seen this market severely impeded, with significant consequences for the functioning of the economy. The assessment of impact focuses on the role of institutions as providers of funding to, or as lenders from, other financial institutions.

<sup>18</sup> C(2016)424, Delegated Regulation of the European Parliament and of the Council on the criteria for the determination of the activities, services and operations with regard to critical functions, 02/02/2016.

### *Substitutability analysis*

- 50 **In line with DR 2016/778, the substitutability analysis takes market structure, impediments to substitution and time to substitution into account** (box 3). For that purpose, it relies on five key indicators: the market share, the number of competitors that could substitute the function, expected time for substitution, legal barriers and operational requirements for competitors to offer the service or enter the market. The incentive for other providers to take over the function and the availability of such providers to take over the function are not explicitly included, as they are difficult to capture with specific indicators.
- 51 **IRTs compare individual entity reports with peers, taking into account their knowledge of relevant markets.** This assessment needs to be consistent across entities operating in the same market, which is why RAs' benchmarking of individual institution responses is essential to arrive at an informed judgment. RAs also verify if institutions' partial responses are consistent with their overall assessment of substitutability. Where internal consistency is lacking, further work is undertaken to find out whether this is justified by other elements, not included in the standard framework, or whether it rests on errors of judgment or other biases.

#### **Box 3: Assessing substitutability**

According to the Commission Delegated Regulation, the supply-side analysis shall include the following elements

- ✓ structure of the market for that function and the availability of substitute providers;
- ✓ ability of other providers in terms of capacity, the requirements for performing the function, and potential barriers to entry or expansion;
- ✓ incentive of other providers to take on these activities;
- ✓ time required by users of the service to move to a new service provider and costs of such a move, and for other competitors to take over the functions and whether the timeframe is sufficient to prevent significant disruption depending on the type of service.

### *Criticality assessment*

- 52 **IRTs review the criticality assessment reported by institutions.** A key aspect considered by the IRT is whether the final conclusion by the institution as to the criticality of the function adequately reflects the assessments of impact and substitutability.
- 53 **The conclusions of the impact and substitutability analyses enable IRTs to construct a *spectrum of criticality* (see figure 5).** This concept was first mentioned by the FSB and assists RAs in assessing criticality under different market circumstances. Understanding why a function has been deemed critical or not at the time of planning, and the degree of certainty associated to that determination is important information. Indeed, during resolution, RAs need to re-assess criticality, focusing in particular on functions for which criticality is not clear-cut.

**Figure 5: Spectrum of criticality**

Please note that this figure is indicative

Impact*	H	rather not critical	uncertain	critical	critical
	MH	rather not critical	uncertain	uncertain	critical
	ML	not critical	rather not critical	uncertain	uncertain
	L	not critical	not critical	rather not critical	rather not critical
		L	ML	MH	H

Supply-side ('H' means 'not substitutable' and 'L' means 'substitutable')

\* 'H' means that the impact is significantly severe and 'L' that it is not material.

- 54 **The criticality of certain functions may be related to that of other functions.** For example, 'deposits' and 'payment services involving non-MFIs' and 'cash services' are frequently regarded as inherently related. There is, however, an important distinction to be made. The deposit function is mainly designed to reflect the store of value function of bank deposits, while the payment function is related to their transactional dimension. As a consequence when deposits are critical, payments are often found to be critical. However, this may not always be the case.

## D- GEOGRAPHICAL SCOPE

- 55 **The SRB considers the national level as the relevant market per default in the Critical Functions Template.** Nevertheless, the template also allows for assessing the impact at different geographical levels (regional/EU/global) in the rare cases in which the default option is not considered adequate. Ultimately, the SRB assesses the impact of the disruption at the national level, taking into account any expected contagion from the relevant market level, as appropriate.

### *Relevant market*

- 56 **The SRB may deviate from the default national level based on demand-side as well as supply-side characteristics.** The demand-side elements relate to customers' preferences (e.g. the proximity of branches or alternative physical access, as well as access to digital services). The supply-side elements relate to specificities in the provision of banking services, as well as the potential presence of other players and threat of competition.

### *Assessment of the impact at the national level or higher*

- 57 **When the relevant market is deemed to be regional, the SRB assesses the potential contagion to the national level.** Without such contagion, criticality at the regional level does not automatically lead to criticality at the level of "one Member State or higher". IRTs perform this assessment with the support of financial stability experts. This analysis is based on existing analytical approaches, taking into account some other relevant criteria contained in the legal framework, and relies on NRAs' expertise with regard to their national markets.

- 58 **The SRB considers several potential contagion channels, amongst which economic and financial interconnectedness and behavioural elements associated with social learning.** The former relies on linkages that affect economic variables, such as the relative size of the region in the country, its relative importance in the provision of a particular function and interbank or economic interconnectedness beliefs about, for example, the apparent similarity between the failing bank and other institutions in the MS.
- 59 **The SRB considers that contagion should be related to particular economic functions.** A comprehensive financial stability analysis rather belongs to the feasibility and credibility analysis of normal insolvency proceedings in resolution plans, as. The latter is related to potential reactions of investors or counterparties driven by
- 60 well as to the PIA.

## GOING FORWARD: NEXT STEPS FOR 2018 AND BEYOND

- 61 **The critical functions analysis is an ongoing process; the identification of critical functions will be refined in the light of concrete experience.** The guidance for institutions, as published on the website of the SRB<sup>19</sup>, has been enhanced in advance of the 2018 data collection exercise, taking into account the Q&As received in 2017 and other feedback from institutions and RAs. The internal guidance for IRTs will also be enhanced in the light of the 2017 experience. Furthermore, the SRB will work on improving its understanding of markets, including through the analysis of appropriate data and information. The SRB is committed to developing its technical capacities in this respect and will continue working together with NRAs to build upon their expertise on national markets.
- 62 **The SRB will take into account the EBA's work on new resolution templates.** The EBA is in the process of updating the ITS on the provision of information for resolution plans (Commission Implementing Regulation (EU) 2016/1066), commonly referred to as the "EBA templates". The draft revised EBA ITS also includes two templates on critical functions: one for the identification of critical functions (a lighter version of the current SRB Template) and one for the mapping of critical functions to legal entities and core business lines. The SRB will (slightly) adjust its template and guidance accordingly to make sure that the EBA and SRB templates are fully compatible.
- 63 **In line with the EBA approach, the SRB is asking for Critical Functions Reports at the national level in the 2018 resolution planning cycle.** In addition, the SRB may continue to perform the assessment for (sub-groups of) entities within a certain MS. Going forward, the SRB will aim to ensure that the information it requests from banks is in line with the forthcoming ITS, and that the same information is not requested multiple times.

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<sup>19</sup> <https://srb.europa.eu/en/content/critical-functions-report>.



## **Single Resolution Board**

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