

## IN-DEPTH ANALYSIS

Requested by the ECON Committee



# The provision of critical functions at global, national or regional level

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Is there a need for further legal/regulatory clarification if liquidation is the default option for failing banks?

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## The provision of critical functions at global, national or regional level

### Abstract

The introduction of a bank resolution framework for EU banks has created the need for clear legal definitions of the main elements in resolution. This paper assesses one of these elements, namely “critical functions”, which encompasses the activities of a bank that are of significant importance for the real economy. The assessment of the regulation and implementation shows that there is room for sharpening the definition and equal application across all banks. It is questionable, however, whether regulatory intervention is necessary given the on-going work of authorities at different levels. In turn, legislative intervention will be required to align the objectives of the resolution framework and state aid. The latter currently leaves more room for public support measures, which are not necessarily in the public interest.

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## EXECUTIVE SUMMARY

The global financial crisis spurred legislators to create a framework to deal with distressed banks. This bank-restructuring framework was initially based exclusively on state aid rules, which provide minimum conditions for public support. Over time, these conditions have been gradually tightened and complemented by the bank resolution mechanism, which provides a more structured approach to resolving distressed banks.

Whereas during the financial crisis most distressed banks were bailed out under the state aid rules, the resolution mechanism contains stricter rules that consider liquidation the default option and allows resolution only when the bank is failing or likely to fail. There is no reasonable alternative and the bank resolution is in the public interest.

This analysis focuses on the concept of public interest in the context of critical functions, which, together with financial stability, forms the main resolution objectives that need to be at risk in order to consider a resolution in the public interest.

The functions (activities, services and operations) are considered critical when provided to third parties and when their sudden disruption would have a material and negative impact on the real economy and financial stability. Indeed, part of the critical functions definition overlaps with the financial stability objective. This is not ideal, but looking at the application of the definition in the critical functions assessment, there seems no immediate need to revise the legal definition.

The critical functions assessment leaves room for flexibility. The assessment consists of two phases. The bank first conducts a self-assessment, which is subsequently reviewed by the resolution authorities, which use them in their resolution plans. The Single Resolution Board (SRB) has issued a template and guidance for conducting the assessment. In 2017, for the first time, all 135 banks under its remit had to conduct the assessment for between 650 and 700 entities. Although the template provides a standard structure, the qualitative nature and best estimates used in the assessment seem to have produced different outcomes for similar banks.

The SRB performs checks on the internal consistency and benchmarking to identify outliers. Nevertheless, according to various experts involved, there are still substantial differences between banks and Member States, primarily due to differences in risk perceptions and the availability of human resources across countries. There are, for example, only on average about two resolution experts per significant bank.

The flexibility in the results of the assessments could be reduced with the introduction of hard regulatory thresholds determining when a function is critical or not. It is difficult, however, to determine these thresholds, which should be adjusted over time given their dependence on economic circumstances. The preferred option would be to use softer measures in the first instance to encourage supervisory and resolution authorities to enhance the equal treatment (new EBA guidelines, stronger benchmarking by SRB, etc.).

The first round of applying the public interest tests to assess critical functions has contributed to the resolution decision, but the results have not been decisive. For example, neither the Banca Popolare di Vicenza nor the Veneto Banca performed critical functions of financial systemic importance, but the Commission approved state aid for their market exit under Italian insolvency law. Hence, the public interest test is currently only applicable within resolution and not to state aid outside resolution (precautionary recapitalisation) and in insolvency proceedings (liquidation aid in insolvency). It is recommended that the resolution authorities/supervisors in these two cases should be required to also perform a public interest test. This would require a revision of the 2013 Banking Communication or the SRMR/BRRD.

## 1. INTRODUCTION

The global financial crisis that erupted more than a decade ago underlined the vulnerability of the European banking sector as well as its importance for the functioning of the economy. In the decade that has followed, many banks in the European Union have been bailed out with taxpayers' money in order to avoid disturbing financial stability. The EU Member States injected about €466 billion (or 3.2% of EU GDP) in capital support and a multiple of that amount in impaired assets and liquidity measures in their banks (European Commission, 2016).

In response to the many public interventions, a framework for bank restructuring has gradually been created, which have tightened the rules for state aid in the process. Indeed, in the early stages, tax money was injected based on ad-hoc decisions of the European Commission (DG Competition), which even in the early days of the crisis issued a communication to establish minimum conditions that should be met in the event of a state intervention in the financial sector. These minimum conditions have been progressively raised in subsequent communications up to the most recent Bank Communication of 2013.<sup>1</sup> These "crisis communications" provide guidance on understanding the role of the European Commission as laid out in TFEU Article 107(3)(b), which allows for state aid to remedy a serious disturbance in the economy of an EU Member State. Indeed, state aid can be granted to safeguard financial stability, while minimising the aid required and distortion of competition. The latter is primarily relevant for banks that will be restructured and less for banks that are liquidated and exit the market.

Ensuring financial stability is thus the main motivation in approving state aid. Let us look more closely at the definition that is provided for financial stability in the Bank Communication (point 7): "Financial stability implies the need to prevent major negative spill-over effects for the rest of the banking system which could flow from the failure of a credit institution as well as the need to ensure that the banking system as a whole continues to provide adequate lending to the real economy." Protecting financial stability can thus be separated into two spill over effects: i) on other banks and ii) on the real economy via the lending channel.

Whereas the Bank Communication has remained unchanged since 2013, the bank-restructuring framework has been changed substantially in the meantime with the adoption of the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism Regulation (SRMR) in 2014. These two legislative packages have formalised the interventions with resolution objectives, tools, planning, plans, etc. They have strengthened the conditions that must be fulfilled before a bank can be resolved. Indeed, liquidation has become the default option in case of bank failures and a bank can only be resolved using the resolution tools and resolution funds when i) the institution is at least deemed failing or likely to fail, ii) there are no reasonable alternatives and iii) the resolution is in the public interest (Article 32[1] BRRD & Article 18[1] SRMR). The remainder of this analysis focuses on the public interest condition.

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<sup>1</sup> [http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:52013XC0730\(01\)](http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:52013XC0730(01))

Resolution is considered in the public interest when resolution is necessary to achieve one or more resolution objectives. There are five resolution objectives, two of which refer to financial stability using somewhat similar notions as the condition for state aid specified in the Bank Communication of 2013:

1. Ensuring continuity of critical functions, which addressed the spill over effects on the real economy via the lending channel, as specified in the Banking Communication, and
2. Avoiding significant adverse effects on the financial system, which covers the spill over effects on other banks in the Banking Communication.

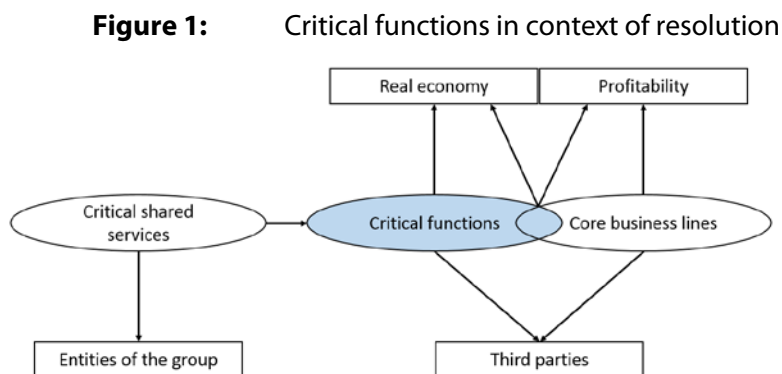
In addition, the resolution objectives also include the minimisation of the reliance on extraordinary public support, protection of depositors and protection of client funds and assets (Article 31[2] of BRRD & Article 14[2] SRMR). The latter, however, seem of lesser importance for the public interest test used to assess whether the resolution is actually in the public interest.

The focus of the present analysis is therefore more on the first resolution objective, ensuring continuity of critical functions. It assesses the regulation and implementation as well as role of critical functions in the broader bank-restructuring framework for the banking union. During the drafting process, the main authorities involved (i.e. Single Resolution Board, European Commission [DG Competition] and a National Resolution Authority) were interviewed. The assessment is further based on recent cases in which the critical functions assessment has been used and other documentation available related to critical functions.

The remainder of the analysis in the second section discusses whether the definition of critical functions and the applicable assessment criteria are sufficiently clear at the level of the Banking Union. In section 3, the implementation of the critical functions is assessed and in particular, whether banks are treated equally. Section 4 assesses the implications of the critical functions and public interest for the broader bank-restructuring framework. Conclusions are drawn in the fifth and final section.

## 2. DEFINING CRITICAL FUNCTIONS

The definition of critical functions in Article 2[1] of the BRRD<sup>2</sup> determines that functions (activities, services or operations) of banks can be considered critical when their discontinuation is likely to lead to disturbance of the real economy or financial stability in at least one Member State. The disturbance must be related to size, market share, internal and external interconnectedness, complexity or cross-border activities of the bank concerned. Moreover, the activities should not be easily substitutable by other banks.



Source: SRB – Guidance on the Critical Function Report (2016a).

The specification of the definition and particularly the determination of the critical functions appear in Article 6 of the European Commission Delegated Regulation (2016),<sup>3</sup> based on Article 2[2] of the BRRD:

*A function is considered critical, if it meets both of the following conditions:*

- (a) *the function is **provided by an institution to third parties** not affiliated with the institution or group; and;*
- (b) *the sudden disruption of that function would likely have a **material negative impact on 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.*

Thus, critical functions are only provided to third parties and not, for instance, to other parts of the banking group. These so-called critical shared services are essential to continue the critical functions to third parties are defined in the same delegated regulation as critical functions, but treated separately in the resolution planning. Moreover, the Single Resolution Board (SRB) differentiates between critical

<sup>2</sup> Critical functions encompass “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>3</sup> See also Annex I for the complete Article 6.



functions and core business lines (see Figure 1). While the definition of critical functions is based on their relevance to the real economy or financial system, the concept of core business lines looks instead at the internal bundling of activities and its relevance for profitability (SRB, 2016a). The two concepts – critical functions and core business lines – are therefore not the same. The creation of the critical functions and core business lines might be important for the profitability of the bank and thus indirectly for the sustainability of the critical functions after resolution.

## 2.1 Policy implications

The main issue from a legal point of view regarding the current definition of critical functions is not clearly distinct from the other resolution objectives. Indeed, there is some overlap between the first and second resolution objective. The first resolution objective to ensure the continuity of critical functions includes the functions that give rise to contagion and the second resolution objective to avoid significant adverse effects on financial stability also considers contagion or spill over effects on the wider financial system. Although it would be preferable to have a clear distinction between the two resolution objectives, this does not seem at present to create any problems in the application of the law. The resolution authorities have addressed this issue in the critical functions assessments (see section 3) by limiting it to the function-specific spillovers (e.g. deposit-taking, impact on deposits from other banks).

### 3. IDENTIFYING CRITICAL FUNCTIONS

Banking and resolution authorities identify critical functions on two particular occasions. Firstly, they are identified on an annual basis in the context of drafting and updating the recovery and resolution plans. Secondly, when the bank is at risk of actually failing, the resolution authority re-assesses the critical functions, to ensure that they have not changed due to new circumstances.

The regular annual assessment, as defined in the delegated regulation, consists of two phases. First, the bank concerned is required to conduct a self-assessment of the critical functions for its recovery plans. Second, the resolution authorities review the critical functions and perform their own assessment for the resolution plans. There is thus an important role for both banks and the resolution authorities.

In 2016, the SRB conducted a pilot study to assess the critical functions of more than ten banks. Based on the experiences with this exercise and the requirements in the delegated regulation, the SRB has drafted a template and guidance on the assessment of the critical functions of all the banks under its remit. This regular assessment was conducted in 2017 for the first time and is likely to be repeated in an almost identical manner in 2018. Moreover, the SRB has already indicated that the guidance and template will be revised for the assessment in 2019. These should bring them in line with the new EU-based guidelines that the European Banking Authority (EBA) is expected to issue based on the initial experiences in the different EU Member States in 2018.<sup>4 5</sup>

#### 3.1 Critical functions assessment

Looking at the most recent assessment conducted in 2017, the banks under the remit of the SRB had to follow the template and guidance of the resolution authority drafted in 2016. The SRB has drafted the template and guidance to provide structure for the data collection and assist the institutions and national resolution authorities (NRAs) in the self-assessment.

The SRB (2016a) template to identify critical consists of four steps derived from the delegated regulation:

##### 1. Selection of economic functions that the institution conducts

The first step only concerns the selection of the functions<sup>6</sup> and sub-functions that are performed for third parties such as deposits and lending. These functions are in turn divided in several sub-functions. The deposit-function, for example, is divided into four predefined sub-functions: households, non-financial corporations (SMEs), non-financial corporations (non-SMEs) and general government. In addition, it is possible to add self-specified additional sub-

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<sup>4</sup> The EBA designs the regulatory minimum for the entire EU. The SRB may therefore ask for more information if it deems necessary.

<sup>5</sup> Between 11 October and 11 December 2017, the EBA is conducting a consultation on “Implementing Technical Standards on procedures, forms and templates for resolution planning”, which includes critical functions.

<sup>6</sup> All functions include deposit, lending, payments, cash, settlement, clearing, custody, capital markets and wholesale funding.

functions. The standard list seems for most of the banks, however, sufficiently granular. Very few banks use the option to add self-specified sub-functions.

## **2. Collecting data for each of the selected economic (sub)functions**

The data collected in the second step for each of the sub-functions includes for example market share, value on accounts, number of clients and cross-border value. Some of this data, such as value on accounts, is already prepared under the official (regulatory) reporting (e.g. FinRep, Corep, and ECB Payments Statistics). But there are also indicators that are traditionally not part of the supervisory or other official reporting such as national and regional market share, number of clients and number of accounts. In fact, the banks might not be in a position to easily provide this data. The resolution authority therefore allows the banks to provide best estimates to get an idea about the order of magnitude.

## **3. Assessment of the impact as well as supply-side assessment**

The third step consists of two broader elements. On the one hand, the impact of a discontinuation of the function is assessed. This includes the impact on third parties, either in the financial markets or in the real economy. The assessment is based on the data provided in the second step. The options provided in most cases are of a relative nature, for example large, medium, small and negligible. On the other hand, the assessment will indicate whether the function could potentially be substituted. This is the case when the function can be replaced in an acceptable way within a reasonable timeframe. The assessment of the substitutability considers an opinion on the market share and concentration, legal barriers, operational requirements and timeframe. All the indicators are based on multiple choice except for market share, which is obtained from the second step. Most of the multiple choice questions are of a relative nature except for the number of competitors<sup>7</sup> and estimated time required.<sup>8</sup>

## **4. Determining whether the selected function is critical or not**

The final assessment on the criticality builds on the impact and supply-side analysis in the third step. It draws conclusions from the impact and supply-side analysis, before ultimately deciding on criticality. The overall impact is indicated for all sub-functions conducted at national level, but the template provides the option to also indicate the impact of the sub-functions at regional level. There are four different conclusions possible: low impact; materially, but limited impact; significant impact; and major impact. For the conclusion on the substitutability, the geographical area is not specified. There are, however, also four different options for the conclusions on the supply-side analysis: not substitutable, difficult to substitute, reasonably substitutable and substitutable. Based on the results of the impact analysis and the supply-side analysis, a conclusion is drawn on whether or not a function is critical.

The SRB asked the 135 banks under its remit to conduct the four-step assessment in principle both at group-level and for all the credit institutions belonging to the group individually. This allows the SRB and NRAs to locate the critical functions in the group structure and ensure the continuation of these functions in the resolution planning. In some cases, however, the internal resolution teams (IRTs) responsible for performing the resolution activities concluded that not all entities had to be individually

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<sup>7</sup> The options range from less than five competitors to more than twenty that could substitute the function.

<sup>8</sup> The options range from less than one week to more than six months.

assessed.<sup>9</sup> The total number of assessments submitted is therefore lower than the number of credit institutions and groups belonging to the banks under the remit of the SRB. Hence, in 2017, the template has been completed for between 650 and 700 entities, which means that the critical functions of the large majority of the about 900 credit institutions belonging to the banks under SRB remit were assessed on a group and individual basis. The SRB further encouraged the NRAs in the euro area to use the same approach to identify potential critical functions of less significant institutions that are under their remit.

### 3.2 Equal treatment

The critical functions assessment forms a pivotal element in the determination of whether a bank will be resolved or liquidated. It is therefore important that critical functions are correctly identified and that all banks are treated equally to ensure a level playing field. At the present time, however, neither the completed critical function templates nor the resolution plans with the results of the critical functions assessments are currently publicly available, which makes it difficult for independent external experts to assess the quality and consistency across banks. We nevertheless make an effort based on the design of the template and observations by experts at the SRB and a NRA interviewed for this analysis.

The current template for the assessment of the critical functions offers quite some room for flexibility. The first two steps identifying the functions and collecting data inputs are quite factual, although they also provide some flexibility. Banks, for example, are allowed to use best estimates, different accounting standards (IFRS and national GAAP) and not all functions are tightly defined based on supervisory or financial reporting. This might potentially lead to different conclusions about the critical functions across similar entities. The main potential source of variation in the results is likely to originate from the third and fourth step to assess the impact and supply-side effect as well as a conclusion on the criticality of the function. These steps are largely based on expert judgement, which leaves potentially ample room for interpretation on the part of the experts filling out the template for the bank that completes the initial assessment and the IRTs that review the assessments.

The SRB has initiated several measures to mitigate part of the potential flexibility that these expert judgements might cause. Indeed, the flexibility is somewhat limited, given the structured approach with a standard template and guidance note. The latter clearly indicates that it is a qualitative assessment, which means that there are no clear thresholds indicating what, for instance, a large market share is. Similarly, there is no standard matrix that indicates whether the function is critical based on the impact assessment and supply-side analysis. The SRB, however, checks the internal consistency in the templates and performs a benchmarking exercise across all the entities for which the template has been completed. These exercises are primarily to avoid large differences between entities. The internal consistency check aims to identify illogical results. For example, the impact analysis indicates that the impact is low and the supply-side analysis indicates that the function is substitutable, but the function is nevertheless identified as critical. Moreover, there is a benchmarking

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<sup>9</sup> For example, when there were no functions listed in the template delivered to third parties, no assessment had to be performed. Moreover, some of the banks were asked to perform the assessment at sub-consolidated level for several entities when there were several entities within the group performing similar functions within one Member State.

exercise performed across all banks to spot outliers. The results of these exercises are provided to the IRTs that take a final decision on the critical functions.

**Table 1:** Resources and responsibilities of the euro area resolution authorities (Nov. 2016)

Resolution authority		Resolution experts	Significant & cross-border banks		Other (less significant) institutions
		FTEs	Groups	Entities	Entities
AT	Finanzmarktaufsicht	7.5	10	100	508
BE	Nationale Bank van België	4.4	8	23	27
CY	Central Bank of Cyprus	2.0	5	8	8
DE	Bundesanstalt für Finanzmarktstabilisierung	57.0	24	73	1,560
EE	Finantsinspektsioon	0.0	2	2	13
ES	FROB/Banco de España	33.0	13	77	75
FI	Rahoitusvakausturvasto	4.5	4	176	90
FR	Autorité de contrôle prudentiel et de résolution	12.2	14	277	119
GR	Bank of Greece	6.0	4	9	18
IE	Central Bank of Ireland	9.0	6	13	28
IT	Banca d'Italia	23.0	14	81	433
LT	Lietuvos bankas	4.0	3	3	8
LU	Commission de Surveillance du Secteur Financier	8.0	4	13	64
LV	Financial and Capital Market Commission	4.0	4	6	16
MT	Malta Financial Services Authority	2.0	3	5	18
NL	De Nederlandsche Bank	13.0	7	30	54
PT	Banco de Portugal	13.4	4	13	116
SI	Banka Slovenije	2.0	3	5	5
SK	Resolution Council	5.0	3	3	11
<b>Total NRAs</b>		<b>209.1</b>	<b>135</b>	<b>917</b>	<b>3,171</b>
EA	Single Resolution Board	91.0	135	917	0
<b>Total</b>		<b>300.1</b>	<b>135</b>	<b>917</b>	<b>3,171</b>

Note: FTEs = full-time equivalents.

Source: Author's elaboration based on Single Resolution Board and ECB SSM (2017)

According to the interviewed experts of the SRB and NRA who have seen several of the critical function assessments, there are still substantial differences across banks and Member States. In their view, these are due to differences in the risk perceptions at national level and in available resources. To some extent, national risk perceptions play a role at the bank level, but primarily for the NRAs that are together with the SRB responsible for the resolution activities within the IRTs. Moreover, the resources for resolution planning are limited in general and also in particular countries, with only a few banks

having a limited number of dedicated experts on staff, whereas for example the policy work is similar as for the NRAs that are responsible for many banks and have larger teams.

Table 1 provides an overview of the human resources and number of entities covered by the SRB and NRAs in the euro area. The data on human resources, collected in November 2016, indicate the number of full-time equivalent (FTE) experts who are working on either resolution planning or horizontal functions such as policy (excluding support functions). There are large differences between the human resources available to NRAs. Almost half of the NRAs (9) have five or less resolution experts, which is partially due to the fact that the smallest NRAs combine resolution with supervision. Another seven NRAs have with between five and fifteen experts. Only a small group of three NRAs have twenty or more resolution experts (DE, ES and IT). These three NRAs combined have more than half of the resolution experts of the euro-area NRAs.

In total, there were 300 resolution experts at resolution authorities in the euro area, of which about two-thirds work for the NRAs and one-third for the SRB. Indeed, roughly two resolution experts per bank under the remit of the SRB (i.e. significant and less significant cross-border banks) seems relatively limited. In particular when you consider that the assessment of the critical functions is only part of the resolution planning and there are on average five assessments of critical functions per bank. Moreover, the experts of the NRAs are also responsible for the resolution planning of less significant institutions that cannot be liquidated.

### 3.3 Policy implications

The consistency of the critical functions assessment across banks can be improved with hard legislative measures or softer non-legislative actions. The first, most pressing option would be hard legislative action, i.e. amending the legislation. Indeed, one could amend the delegated legislation and introduce clear thresholds, but it would be difficult to formulate the appropriate levels. On the one hand, the impact and substitutability are likely to be different across Member States, for instance due to national specificities regarding dependence on financial services. On the other hand, the criticality of functions is likely to change over time depending on economic and financial conditions. More specifically, a function might be considered not critical in good economic times, whereas critical during economic or financial crises. A hard legislative threshold would have to be set at the lower levels to ensure that no critical functions are missed, meaning that more functions are considered critical than is strictly necessary. This could have the ultimate consequence that more banks than necessary are resolved.

The second preferred option would be of a softer nature, linking the policy measures to the on-going revisions at the euro-area and EU levels. The introduction of the critical functions assessment is still relatively recent, with the SRB conducting the exercise in 2017 only for the second consecutive year and for the first time on all the banks under its remit. The resolution authorities seem still in a learning process. In the short run, it might therefore be better to use soft measures to encourage the resolution authorities to enhance equal treatment. An important step could be taken with EU-based guidelines from the EBA in 2018. In particular, the harmonisation of the templates as well as clear, detailed guidance at EU-level could, when implemented across Member States, lead to a convergence in the practises of NRAs. Moreover, the SRB could also contribute to the convergence in the treatment of the banks under its remit by strengthening the benchmarking process in the Banking Union. In particular, performing the process against peer groups of similar types of banks instead of all or only globally systemically important banks, which in some cases have very different business models. The latter would allow for the SRB to give more centralised guidance on the determination of the critical functions. Lastly, part of the inconsistencies between banks is likely to be resolved over time, when the

critical functions assessment is repeated several times and the experts of the resolution authorities can delve more deeply into specific elements of the assessments, which they are currently unlikely to be able to do given the limited human resources available at many NRAs.

## 4. CRITICAL FUNCTIONS, PUBLIC INTEREST AND STATE AID

The critical functions assessment is just one of the criteria that can potentially justify the resolution of a bank. The bank resolution must also be in the public interest in order to allow the resolution authorities to intervene. This is the case when at least one of the resolution objectives is at risk. These conditions include: i) critical functions, ii) significant adverse effect on the financial system, iii) minimisation of the reliance on extraordinary public support, iv) protection of depositors and investors, as well as v) protection of client funds and assets (Article 14[2] of SRMR).

The public interest test determining whether or not a resolution is in the public interest needs to be conducted at the moment the bank is failing or likely to fail (Article 18[1](a) of SRMR) and there are no alternative private or supervisory measures that could prevent the failure within a reasonable timeframe (Article 18[1](b) of SRMR). The public interest test consists of the two elements: at least one or more resolution objectives needs to be at risk and normal insolvency proceedings would not meet those resolution objectives (Article 18[5] of SRMR).

The public interest test as currently conducted by the SRB includes the two elements as outlined in the legislation, but assesses only for part of the resolution objectives in detail whether they are at risk. In fact, as of November 2017, the SRB has communicated the results of three public interest tests: for Banco Popular Español (7 June 2017), Veneto Banca (23 June 2017) and Banca Popolare di Vicenza (23 June 2017). These tests indicate whether the failing or likely-to-fail bank i) performed critical functions and ii) had significant adverse effects on financial stability. For the remaining resolution objectives, they only assessed whether normal insolvency would achieve at least the same result.

In the case of Banco Popular (€148 bn total assets end-2016), the SRB concluded that the bank both performed critical functions and needed to be resolved to avoid adverse effects on financial stability. According to the notification, the functions of deposit-taking from households and non-financial corporations, lending to SMEs, and payments and cash services were critical. According to the SRB, the normal Spanish insolvency proceedings would not meet the resolution objectives to the same extent as resolution. The bank was resolved using the sale of business and bail-in tools to continue the critical and systemically relevant functions and cover the losses.

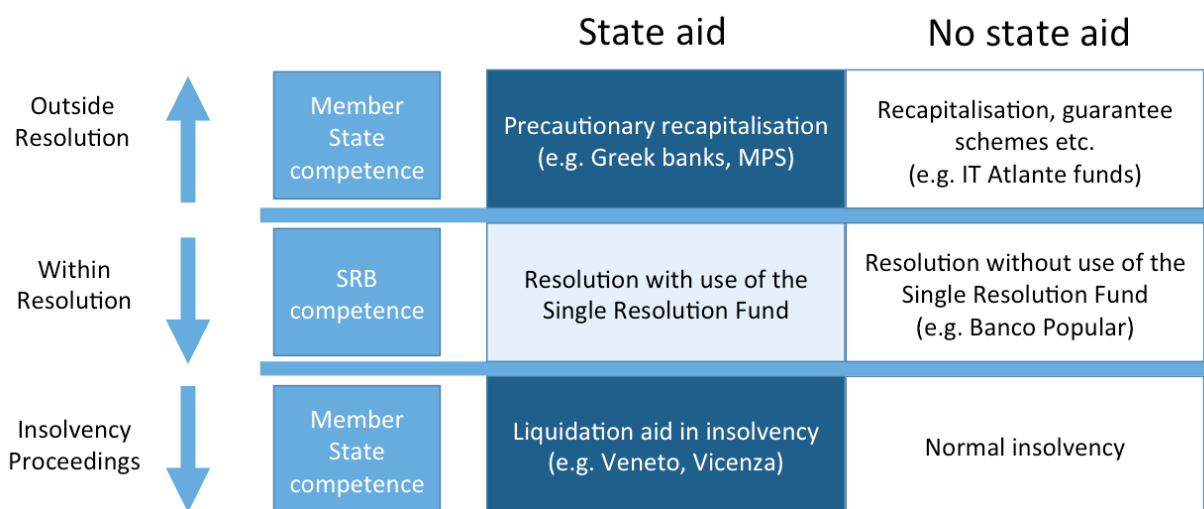
For Veneto (€28 bn total assets end-2016) and Vicenza (€34 bn total assets end-2016), the SRB concluded in near-identical notices that the deposits, lending activities and payment services are not critical functions since they are only provided to a limited number of third parties and that the potential alternatives are acceptable and can be provided within in a reasonable timeframe. The failure of the banks was considered not to have negative spill over effects on the other banks given their limited financial and operational interconnectedness. Moreover, normal insolvency provided a similar level of protection to depositors, investors, other customers as well as funds and assets of clients. According to the SRB, the banks could thus be liquidated under the normal Italian insolvency proceedings.

Overall, based on these initial public-interest tests, the critical functions contributed to the decision whether to resolve a bank or not, but they were not decisive. Hence, the failure of large significant banks such as Banco Popular is likely to also cause significant adverse effects on financial stability, whereas the failure of less significant and smaller significant banks, such as Veneto and Vicenza, will usually have no effect on financial stability, making the assessment whether they still provide critical functions more important. The critical function assessment is therefore currently primarily important for medium-sized significant banks and in some particular cases for small significant or less significant banks that are not of systemic importance for the financial system.



Moreover, the cases of Veneto and Vicenza also showed an important inconsistency between the resolution mechanism and the state aid regime. Although the SRB concluded that resolution was not in the public interest, the two Venetian banks eventually received public support (i.e. capital support plus guarantee) from the Italian government for the liquidation. The Italian authorities deemed the public support necessary to mitigate the effects of the exit from the market. The liquidation of these banks would have a serious negative impact on the real economy in the regions where these banks are most active. The European Commission (DG Competition) (25 June 2017) approved the state aid since it was in line with the Banking Communication of 2013. More specifically, it followed the Italian authorities on the negative effects on the real economy. Moreover, it deemed distortion of the competition limited since the banks would exit the market and the intervention complies with the burden-sharing requirement since the subordinated debt holders were bailed-in.

**Figure 2:** Bank restructuring framework in Euro area



Source: Author’s elaboration

#### 4.1 Policy implications

It remains an undesirable situation that public money is being used to bail out banks, whereas the public interest is at least questionable based on the more comprehensive assessment of the SRB. Hence, the critical functions assessment includes the option to include the impact at regional level in the assessment. In turn, the Banking Communication of 2013 only assesses the impact on the real economy, not whether these critical functions can be replaced in an appropriate manner and timeframe. In that sense, the requirements for the critical functions seem more stringent and comprehensive. This should be considered in an internal revision of the Banking Communication of 2013, which DG Competition is currently contemplating internally.

Alternatively, the SRMR and the BRRD might have to be amended to ensure consistency across the different bank-restructuring regimes. Indeed, to ensure that both precautionary recapitalisation, resolution with the use of the single resolution fund and liquidation aid in insolvency are in the public interest (see Figure 2). The public interest test might have to be amended, since the nature of the public interest in the case of precautionary recapitalisation and liquidation aid in insolvency is different from resolution. The public interest for precautionary recapitalisation lays in enabling a capital-restrained but viable bank to continue lending to the real economy (De Groen, 2017). For liquidation aid in insolvency, the public interest is primarily to limit the losses for the deposit guarantee scheme and to a lesser extent for the other creditors.

Finally, the supervisory or resolution authority should perform the public interest test. In its decisions, the European Commission (DG Competition) follows currently the assessment on the relevance for the real economy and/or financial stability from the authority that requests the approval for state aid. For example, in the case of the Veneto and Vicenza banks, it followed the assessment of the Italian authorities that requested the approval and not that of the SRB, which deemed the intervention unnecessary. Given that the expertise on bank restructuring is concentrated within the resolution authorities, these seem to be the best-placed authorities to perform the public interest tests for both resolution and state aid in insolvency. Similarly, the supervisory authorities seem best positioned to assess the public interest for precautionary recapitalisation.

## 5. CONCLUSIONS

This analysis has focused on various aspects of critical functions, which, together with financial stability, form the main resolution objectives. The findings show that there is room to sharpen the definition to make the critical functions assessment fit better with the other resolution objectives. This does not necessarily require intervention from EU legislators since the implementation of the critical functions assessment has largely clarified the overlap in the legal definition between critical functions and financial-system relevance.

The flexibility in the critical functions assessment could also be addressed without legislative intervention. The convergence might happen automatically when the supervisors and resolution authorities review the existing templates and guidance as well as repeat the exercise a couple of times and make the benchmarking exercise more granular.

Moreover, the consistency between the three current types of restructuring aid for the financial sector could be increased by introducing a public interest test, which is currently only used for resolution, also for precautionary recapitalisation and liquidation aid in insolvency. The public interest tests for these situations would have to be fine-tuned, anticipating the difference in public interests in these situations (e.g. maintaining the lending channel, deposit guarantee scheme).

Finally, the assessment of critical functions is an extensive and cumbersome process that is primarily being used at present to justify resolution. Most of the resolution actions, however, are still being performed at bank-group level. Ideally, the critical functions assessment should in the future be used to make the resolution more targeted, for example by separating the critical functions from the other activities in resolution and ensuring that only those are maintained.

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## ANNEX I: CRITERIA RELATING TO THE DETERMINATION OF CRITICAL FUNCTIONS

EU Commission Delegated Regulation (2016)

### Article 6 Criteria relating to the determination of critical functions

- (1) A function shall be considered critical, where it fulfils both of the following:
  - (a) the function is provided by an institution to **third parties not affiliated to the institution or group**; and
  - (b) the sudden disruption of that function 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.
- (2) When assessing the material negative impact on third parties, the systemic relevance of the function for third parties and the systemic relevance of the institution or group providing the function, the institution and the resolution authority **shall take into account the size, market share, external and internal interconnectedness, complexity, and cross-border activities of the institution or group**.

The assessment criteria for the impact on third parties shall include at least the following elements:

- (a) 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.
  - (b) 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.
  - (c) 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.
  - (d) the **potential disruption of the function** on markets, infrastructures, 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.
- (3) A function that is essential to the real economy and financial markets shall be considered **substitutable where it can be replaced in an acceptable manner and within a reasonable timeframe** thereby avoiding systemic problems for the real economy and the financial markets.

When assessing the substitutability of a function the following criteria shall be taken into account:

- (a) the **structure of the market** for that function and the availability of substitute providers;
- (b) the **ability of other providers** in terms of capacity, the requirements for performing the function, and potential barriers to entry or expansion;

- (c) the **incentive of other providers** to take on these activities;
  - (d) the time required by users of the service to **move to the new service provider** and costs of that move, the time required for other competitors to take over the functions and whether that time is sufficient to prevent significant disruption depending on the type of service.
- (4) A service is considered critical where its disruption can present a serious impediment to, or prevent the performance of, one or more critical functions. A service is not considered critical where it can be provided by another provider within a reasonable timeframe to a comparable extent as regards its object, quality and cost.
- (5) The disruption of functions or services shall consist in functions and services that are no longer provided to a comparable extent, under comparable conditions and of comparable quality, unless the change in providing the function or service concerned takes place in an orderly manner.

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The introduction of a bank resolution framework for EU banks has created the need for clear legal definitions of the main elements in resolution. This paper assesses one of these elements, namely “critical functions”, which encompasses the activities of a bank that are of significant importance for the real economy. The assessment of the regulation and implementation shows that there is room for sharpening the definition and equal application across all banks. It is questionable, however, whether regulatory intervention is necessary given the on-going work of authorities at different levels. In turn, legislative intervention will be required to align the objectives of the resolution framework and state aid. The latter currently leaves more room for public support measures, which are not necessarily in the public interest.

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