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EBA Report

Recovery planning

Comparative report on the approach to determining critical functions and core business lines in recovery plans

Contents

Introduction

In light of the implementation of Directive 2014/59/EU (the Bank Recovery and Resolution Directive — BRRD) in January 2015, and given the role of the EBA as defined in Article 25 of the EBA Regulation, the EBA is tasked with contributing to and actively participating in the development and coordination of effective recovery and resolution planning. Peer group analysis in the form of comparative reports fully aligns with this mandate, promoting higher quality and more consistent recovery and resolution planning across Europe.

In line with this mandate, the EBA compared the recovery plans of 27 European cross-border banking groups, with a specific focus on examining how credit institutions have approached the treatment of critical functions (CFs) and core business lines (CBLs) in their recovery plans.

The feedback from this comparative analysis has contributed to the technical advice on the delegated act on CFs and CBLs provided by the EBA at the request of the European Commission. It is therefore published in conjunction with this report.

During 2015 and 2016, this peer group report will be followed by other comparative papers focused on specific issues (such as the approach to scenario testing) and core aspects of recovery plans (such as the comprehensive assessment of key elements of recovery plans post BRRD implementation).

According to Annex A (point 7) of the BRRD, the identification of CFs is key information to be included in recovery plans. The final draft regulatory technical standard (RTS) on the content of recovery plans contains a number of provisions relating to how CFs and CBLs should be addressed. For instance, it requires that, amongst other things, a recovery plan:

- contains a strategic analysis that describes the institution or the group, identifies its CBLs and CFs and specifies the key steps to maintaining these CBLs and CFs in a situation of financial stress;
- in describing the entity or entities that are covered, contains a description of the process and metrics for identifying the CBLs and CFs;
- in terms of recovery options:
  - demonstrates how capital and liquidity actions will ensure the viability of the CFs and CBLs;
  - contains an assessment of the impact and systemic consequences on CFs; and
  - includes a detailed description of the processes for determining the value and marketability of core business lines.

The correct identification of CFs and CBLs is important in the context of recovery planning, for example to determine which business activities need to be continued to restore the firm's long-term viability and financial position and whether recovery options could be implemented without any significant adverse impact on the financial system and maintenance of CFs.

The comparison exercise described in this paper outlines how the analysis of CFs and CBLs has so far been carried out by credit institutions, and also identifies key strengths and weaknesses in their approaches. As recovery plans are still developing, the EBA is using this review to determine the range of practices currently observed across the industry.

Since recovery planning is a relatively new area of regulation, the report should assist credit institutions in identifying best practices and their positioning in relation to peers, ultimately contributing to ensuring that their approach to assessing CFs and CBLs is correctly addressed in recovery plans.

This comparative document should also provide useful input for resolution authorities determining CFs as a key part of their resolution planning and resolvability assessments and for national competent authorities reviewing recovery plans by providing them with an overview of current and best practices for determining CFs and CBLs in recovery plans.

1. Preliminary considerations

1. Ahead of the main findings, the following key observations should be helpful for understanding the outcomes of the exercise.

    - A total of 27 recovery plans were considered from banks headquartered in 12 EU Member States accounting approximately for around half of EU banks' total assets. However, the core analysis focussed on fewer plans since CFs and CBLs were covered in 12 and 17 of the total number of plans respectively. Therefore, while the sample population is reasonable for a comparative analysis, it is important to bear in mind that coverage is not comprehensive.

    - As the BRRD and the final draft RTS on the content of recovery plans require these elements to be included in recovery plans from next year, the sample will be broadened, allowing a more comprehensive comparison exercise to be completed at a later stage.

    - The plans reviewed are at various stages of development and were produced at different times in 2013 and 2014. Most were received before the BRRD was published in June 2014. All recovery plans reviewed are therefore pre BRRD implementation.

2. Approach

2. The analysis of CFs and CBLs in recovery plans were examined and benchmarked in a two-step approach against a series of pre-defined general questions and assessment criteria. These were mostly derived from the Financial Stability Board (FSB) guidance paper[1] on identification of critical functions and critical shared services.

- The first step in the EBA analysis was to develop a template consisting of a list of general questions aimed at understanding the level of detail and granularity of the approach taken and descriptions (e.g. identification criteria, type of definition, level of analysis) of CFs and CBLs included by credit institutions in their recovery plans. Annex I provides the list of general questions against which the plans were assessed.

- The second step was to identify the assessment category and related underlying factors used by the credit institution to determine the 'criticality' of each function. In line with the FSB guidance paper, the following assessment categories were included in the EBA assessment template:

  (i) Analysis of the impact of sudden discontinuance of that function ('impact assessment'). This category is focused on the impact of the failure of a function on external parties.

  (ii) Evaluation of the market for that function ('supply-side analysis'). This category assesses criticality on the basis of the structure of the supplier market and speed of substitution.

  (iii) Assessing criticality of the institution for the function ('firm-specific test'). This category is focused on how critical the credit institution is in providing that function.

Annex II provides a list of specific underlying factors for each assessment category against which recovery plan were benchmarked.

[1] FSB paper *Guidance on Identification of Critical Functions and Critical Shared Services*, 16 July 2013

3. Critical functions

3.1 General considerations

3. Before looking in detail at how credit institutions have approached the identification of CFs in their recovery plans, the following general considerations should be noted.

- Overall credit institutions continue to make good progress in the preparation of recovery plans. With regard to the identification of CFs, when included, banks made efforts to perform this analysis achieving an adequate basis for further improvement. The EBA recognises that defining CFs is a relatively new concept for credit institutions and identifying CFs is therefore particularly challenging.
- The analysis performed by the EBA showed that the identification of CFs was included in a limited number of the recovery plans reviewed. However, this mostly reflects the fact that, until the BRRD came into force on 1 January 2015, credit institutions were under no obligation to address these matters in their plans, although their inclusion was recommended in the FSB Key Attributes and EBA template[2] issued in 2012. In some jurisdictions, the national policy guidance was to address CFs only in resolution planning and credit institutions in these jurisdictions therefore did not include the relevant elements in their recovery plans.
- Although the review identified substantial variation across banking groups in terms of the overall approach to identification, the level of detailed analysis envisaged by the FSB paper was not applied consistently and the approach to identification in some cases consisted of a brief description of the function and a criticality assessment, which was often based on a judgmental evaluation and qualitative considerations rather than being supported by quantitative information and objective and detailed analysis.
- The analysis of CFs by banks was mainly based on the criteria of *systemic importance* and *substitutability*. For these criteria, banks produced a wide range of quantitative data complemented by clear and well-documented expert judgment. However, only a few banks undertook more complex analysis focused on assessing contagion effects and interdependence with other markets complemented by in-depth explanation of the underlying valuations. While recognising the challenging nature of this type of assessment, failing to include it could potentially result in functions being missed that would otherwise have been considered critical.

[2] EBA *Discussion Paper on a template for recovery plans*, 15 May 2012. The instruction given in the EBA template was 'a description of critical or systemically relevant functions performed by the group. This primarily concerns external functions, such as payment systems and services provided to other institutions, but also include centralised functions that are critical for the group, such as treasury, collateral management, IT, access to market infrastructures (as recipient and as provider), administrative, operational, outsourcing'.

- Some credit institutions have expanded the concept of critical function to include critical shared services, in line with the FSB definition. Although this distinction is not fully defined in the BRRD, as the disruption of critical shared services may lead to the discontinuation of the critical functions an institution performs, the analysis could undoubtedly benefit from an assessment of CFs that also includes these services.
- Generally, the analysis of CFs is not effectively linked to other core aspects of the recovery plan such as recovery options, governance and indicators. In most cases, credit instutions acknowledge that one objective of the recovery plan must be to ensure continuation of its CFs under a stress situation, but this concept is not developed further. As a result, in their analysis of recovery options for example, most credit institutions do not consider their relationship with CFs nor whether their implementation could restore or damage continuation of the service. In a few cases, the credit institution simply states that the recovery option will not have an impact on its provision of CFs.
- Where CFs were analysed, they were primarily examined on a national market basis. This probably reflects the fact that, at this level, the assessment of their systemic importance is easier. However, for banks that are more globally active, regional and global parameters were sometimes used.

3.2 Definition

4. In seven of the twelve plans analysed, banking groups created their own ad-hoc definition of CFs drawing on elements of official wording. Of the other cases considered, the banking groups used the wording of national policy[3] documents in two cases, the BRRD[4] in two cases and the FSB[5] in only one case.

[3] BaFin definition (from *Mindestanforderungen an die Ausgestaltung von Sanierungsplänen – MaSan - The Minimum Requirements for the Design of Recovery Plans*): critical activities are business activities that, if discontinued or improperly managed, could have a considerable negative impact on other companies in the financial sector, on the financial markets or on the general confidence of depositors and other market participants. This also includes financial instruments.
PRA definition: a 'critical economic function' (CEF) is a product/activity of the firm whose withdrawal or disorderly wind-down could have a material impact on the UK economy or financial system. More likely to be considered critically important if that firm provides a material proportion of total system capacity and/or there are few or no other firms which would be willing to step in as substitute providers.

[4] BRRD definition: critical function means 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, with particular regard to the substitutability of those activities, services or operations.

[5] FSB definition: critical functions are activities performed for third parties where failure would lead to the disruption of services that are vital for the functioning of the real economy and for financial stability due to the banking group's size or market share, external and internal interconnectedness, complexity and cross-border activities. Examples include payments, custody, certain lending and deposit-taking activities in the commercial or retail sector, clearing and settling, limited segments of wholesale markets, market-making in certain securities and highly concentrated specialist lending sectors.

5. In general, the definitions used by banking groups were clear in highlighting that CFs relate to the provision of services to third parties and that they are vital to the real economy and the financial stability of Member States. However, a material weakness that emerged in some cases was that the authors included the concept of the function being important to the group or the potential impact on the group in case of failure, thus creating confusion with the concept of CBLs.

3.3 Assessment criteria

6. In line with the FSB guidance, *systemic importance* and *substitutability* featured regularly as the main preferred assessment criteria banks used to identify CFs. The FSB criteria of 'impact assessment' (i.e. how critical is the provision of this service to end users? Is this market crucial to the functioning of other markets?) was considered by fewer banks, with high-level qualitative considerations largely focused on how critical services are to customers. In addition, few banks considered in their analysis of CFs the likelihood of contagion to other institutions/markets.

3.4 Systemic importance

7. Use of the 'systemic importance' criteria by banks to determine the criticality of a business function was widespread across banks. Their judgment was supported by a good range of quantitative information to identify whether or not their role within the market for that function could be critical to market stability. The following examples were indicators used by banks to assess their systemic importance in providing an economic function:

Criteria	Key question	Indicators
Size	What is the level of activity? What is the competitive position of the bank in the reference market?	• *Market share* • *Volumes* • *Number of transactions* • *Number of customers* • *Number of customers with bank as principal bank*

8. There was no consistency in the specific quantitative benchmarks associated with each metric and most banks did not indicate standard pre-defined market share thresholds to determine criticality. Therefore, thresholds levels for market share varied significantly between banks for the same function, mainly reflecting the features of the market and its degree of concentration in particular, as well as the specific nature of the CF being examined.

9. For economic functions like retail deposits, a market share of between 3% and 5% was generally considered a level appropriate for determining criticality, considering that the market for this service is often fragmented. In the case of payment or asset management activity, the minimum market share level was often set at a higher level (more than 10%), reflecting the standardised nature of these functions and ease of substitution.

10. Two banks set the minimum market share threshold levels to guide them in their determination of CFs at 10% and 12% respectively.

3.5 Substitutability

11. The most common factors considered in assessing substitutability were the number of providers, the concentration of the market and potential barriers to customer switching or competitor entry into the market. Banks were generally able to support the concentration factor using information available internally (such as the number of players in the market and their respective market shares), and often identified criticality where the bank was one of the top five players in the market.

12. Other important aspects of analysis such as the potential costs involved, the difficulty of substitution (i.e. willingness and ability of competitors to substitute the failing bank) and speed of substitution, are included in only a few cases. Some banks attributed the lack of more detailed analysis of these factors to the difficulty in taking a view on the ability, willingness and speed of substitution of their competitors or customers. Where included, this assessment was based on a judgment based on the operational readiness of competitors, their potential spare capacity and their risk appetite under stress scenarios.

13. The key aspect of 'speed' of substitution within a reasonable timeframe is considered only by two banks. These banks set the maximum timeframe for substitution of the service at 30 days. When assessing this element, the key factors considered were how customer-tailored the product was and the degree of operational support it required.

Criteria	Key question	Indicators
Substitutability	Are there alternatives available within a reasonable timeframe and at a reasonable cost?	• *Number of providers* • *Degree of market concentration* • *Entry/exit barriers* • *Capacity of competitors to absorb additional business* • *Speed of substitution*

3.6 Impact

14. An assessment of the impact on external parties of failure to provide a function, including systemic aspects such as contagion effects and the loss of market confidence, was included in only a few cases. Where it was included, banks seemed clear on the aspects to be considered in the analysis of this factor, including the impact on/losses incurred by other financial market participants and the impact on the real economy. However, their analysis simply consisted of scoring these elements and did not provide an explanation of the specific factors considered in order to derive their final valuation.

15. The impact on other financial market participants was the only element for which some banks provided some basic information supporting their opinion in terms of interbank exposures and derivative holdings.

Criteria	Key question	Indicators
Impact	Is there any impact on/losses incurred by customers, markets and infrastructure? Is there an impact on other markets and/or the real economy?	• *Interbank exposures* • *Derivative holdings*

3.7 Type/number of functions and criticality rationale

16. The type and number of functions identified by banks was largely dependent on the size of the bank and diversification of its business profile. The median of the sample reviewed was 11 functions. Two banks in the peer group ranked the functions in terms of the degree of criticality.

17. The most common type of functions identified as critical by banks were retail deposit taking and lending, corporate lending and payments. Within these critical activities, products such as current accounts for deposit taking, mortgages in retail lending and cash and bank transfers for payments were specifically identified in a number of cases. Derivatives and secondary markets trading were also deemed critical by a considerable number of banks, mainly on the basis of the high notional amounts and operational capacity issues for rapid substitution.

18. The following tables provide a list of the most common types of CFs identified by the peer group banks. It also summarises the most common reasons provided by banks to justify their categorisation as critical functions. These mostly fall into the 'systemic importance' and 'substitutability' category. The table divides the CFs into 'high frequency' and 'medium frequency' depending on how many peer group banks considered them as critical. More specifically, functions deemed critical by more than five (out of 12) banks are considered to be high frequency; medium frequency functions were considered critical by the remaining banks.

Critical functions — high frequency

Function	Number of banks	Criticality rationale
Retail deposit current accounts	11	High market share and volumes, customer need for continuous access to own funds, hard to substitute without disruption
Retail lending (including mortgages)	11	High market share impact on substitutability, stricter borrowing requirements from substitutes
Payments (cash/wire services)	9	High market share, critical for customers' daily operations and payment system, hard to substitute due to need for large IT infrastructure
Corporate lending	8	High market share, liquidity impact and possible contagion effect
Corporate deposits	6	High market share, impact on customers' viability, contagion effect
Clearing and settlement	6	High market share, liquidity provider to interbank market, low number of substitutes due to IT infrastructure
Derivatives (interest rate, FX, equity)	6	High market share, impact on risk-hedging instrument for corporates

Critical functions — medium frequency

Function	Number of banks	Criticality rationale
Secondary market trading	5	High volumes, financial stability impact
Debt capital markets	4	High volumes, financial stability impact
Custody services	4	Impact on client ability to access own securities with potential contagion effect on financial stability
Retail lending (credit cards)	3	High market share impact on substitutability, stricter borrowing requirements from substitutes
Retail savings accounts	3	Impact on client access to own funds, financial stability impact
Trade finance	2	High market share despite high product standardisation
Asset management	2	High market share despite high product standardisation
Leasing	1	High market share
Corporate advisory services	1	High market share
Prime brokerage	1	High market share

3.8 Mapping

19. Seven out of the twelve banks mapped the CFs to legal entities of the group with the mapping exercise usually consisting of a table listing the CFs identified and the group entities in which the function is carried out.

20. The underlying criteria guiding the mapping were not included in the exercise and where, for example, a CF is carried out by two or more entities in the group, there was no indication of their relative importance in providing that function. The basic structure of the mapping exercise performed by the majority of peer group banks could limit the usefulness of this information in the context of recovery planning (for example, when assessing whether the disposal of a group entity could seriously harm the continuation of a CF provided by the credit institution).

4. Core business lines (CBLs)

4.1 Key findings

21. Banks were familiar with the concept of CBLs and, while not always extensively addressed, they were generally better covered than CFs.

The following points are important in relation to CBLs:

- The definitions used were generally in line with the BRRD definition[6].
- Banks mostly drew on contribution to revenue and profits to identify their CBLs. In other cases quantitative criteria were combined with qualitative factors such as the strategic and operational importance to the group or franchise value. In a few cases, no criteria were defined.
- CBLs often coincide with the main business lines reported and described in the annual reports and used for financial reporting. However, there was broad recognition that CBLs change over time and change with the strategy of the organisation.
- CBLs were generally analysed on a group basis but regional criteria were also included in some cases.
- The table below shows the quantitative and qualitative criteria used by banks to identify CBLs.

[6] 'core business lines' means business lines and associated services which represent material sources of revenue, profit or franchise value for an institution or for a group of which an institution forms part.

Criteria for identifying core business lines

Quantitative criteria	Contribution to group revenues	**Qualitative criteria**	Strategic impact/importance to the group
	Contribution to operating profit		Franchise value/strength
	Economic capital		Market potential/growth
	Nominal earnings and % of pre-tax operating profit		Regulatory threats
	Total assets/assets under management		Operational synergies to group
	Market share/industry position		Funding/liquidity source
	Loan/deposit volumes % of group total		Group strategy and cultural fit
	Risk absorption (RWAs) and average capital employed		Customer value
	Capital efficiency		
	Return on total capital		
	Return on assets (ROA)		
	Leverage		
	Cost efficiency		
	Economic profit/economic added value		
	Revenue CAGR (compound annual growth rate)		

5. Annex I

EBA assessment template

5.1 General questions — critical functions
Are critical functions materially dealt with in the recovery plan?
Are critical functions clearly defined in the recovery plan?
If yes, has the definition of critical functions been provided?
BRRD/FSB definition
Other definition
Is it clear in the plan that critical functions relate only to services to third parties/the economy?
Are critical functions described individually?
Has the institution provided the mapping of its critical functions to group material legal entities and branches?
Does the analysis of recovery options demonstrate the ability of these options to restore the viability of each critical function?
Does the recovery plan demonstrate that the execution of the recovery options will not damage the firm's ability to continue to provide CFs?
Does the plan show how critical functions and core business lines could be legally and economically separated?

5.2 General questions — core business lines

Are core business lines defined in the recovery plan?
Which criteria have been used to identify core business lines?
▪ Strategic criteria
▪ Financial criteria
Is each core business line described in the recovery plan?
Has the significance of the core business lines been assessed?
Has the institution provided the mapping of its core business lines to the group material legal entities and branches?
Are core business lines analysed at group, national or regional legal entity level?
Are governance arrangements and escalation procedures for core business lines and related material legal entities covered in the recovery plan?
Does scenario testing consider the impact of stress events on the core business lines?
Has the institution set specific recovery plan indicators for each core business line?
Does the recovery plan provide an analysis of recovery options available to restore each core business line?

6. Annex II

EBA assessment template

Assessment category	Factors
Analysis of the impact of sudden discontinuation of the function	Analysis of the nature of the activity Analysis of disruption of the function on markets and infrastructure Analysis of the disruption of service on customers Analysis of the disruption of service on market participants other than customers Is the market crucial to the functioning of any other markets? Interdependencies? Is the product/service sold alone or tied in to any other products? Other
Evaluation of the market for that function	The concentration of the market How similar are the institutions that dominate market share? Analysis of the extent to which dominant players are also dominant in other markets Analysis of the impact of a dominant player How small a market share would a player need to have to fail without significantly disrupting the activity? Are clear substitutes available? Analysis of the factors that are needed to carry out this activity Are there reasons why existing dominant players would find this business attractive?

Assessment category	Factors
Evaluation of the market for that function	How do firms compete for this activity? Is there evidence that this market is highly substitutable? How quickly would a substitute service provider need to be found to prevent significant disruption? Does a transaction involve extended exposure to a client (requiring greater due diligence)? Are there barriers to entry for new service providers, and what form do these barriers take? How quickly can users of the service move to new service providers? How extensive is the expertise and training needed for employees to provide this service? How tailored or customised is the product? Are regulatory approvals necessary? Other
Assessing criticality of the institution for that function	Market share Could the absolute and relative volume of business hamper the effectiveness of crisis measures? How does the function in question relate to other functions of the firm or of the market? Does the failure of the firm to provide a function send out a 'systemic signal'? Other