WORKING PAPER SERIES

WORKING PAPER
N. 150
DECEMBER 2020

Incentive compatible relationship between ERMII and Close-Cooperation in the Banking Union: The case of Bulgaria and Croatia

By María J Nieto and Dalvinder Singh

Università Bocconi
BAFFI CAREFIN
Centre for Applied Research
on International Markets, Banking,
Finance, and Regulation

Incentive compatible relationship between ERMII and Close-Cooperation in the Banking Union: The case of Bulgaria and Croatia

María J Nieto*

Dalvinder Singh¨

Abstract

The ambition to expand participation in the European Banking Union was to allow the 'outs' to enter in to close cooperation, however, it did not include the simultaneous joining of ERM II. Focusing on the cases of Bulgaria and Croatia, this paper attempts to respond to a number of questions: What is the rationale behind the double requirement of having to simultaneously apply to become a member of the ERM II and to prepare to become a member of the Banking Union via rule based "close cooperation" mechanism of coordination between the EU non-euro area NCAs and the ECB? Does the integration of close cooperation countries' banking systems with the euro area banking systems support the decision to join ERM II and ¨opting-in¨ to the SSM? Do the existing "close cooperation" arrangements guarantee greater coordination of resource-allocating decisions on prudential supervision and improved internalization of financial stability decisions? What are the advantages of the preparation to become a full member of the euro area and the SSM (e.g. coordination of macro and micro-prudential regulation; coordination of micro-prudential supervision and bank resolution)? It is evident from the research undertaken in this paper that there are clear benefits from close cooperation for the respective Member States whose domestic currencies are already linked to the euro in view of the dominant position eurozone banks have in their respective domestic markets.

JEL Codes

E02, E44, F15, G15, G21, H12, K23

Keywords: Banking Union, Close Cooperation, ERM II

* Maria J Nieto, Senior Advisor, Financial Stability, Bank of Spain. The views expressed here are those of the authors and do not necessarily represent those of the Bank of Spain or the Eurosystem.

¨ Dalvinder Singh, Professor of Law, University of Warwick, UK

> "The euro is meant to be the single currency of the European Union as a whole. All but two of our Member States are required and entitled to join the euro once they fulfil the conditions."
>
> Jean-Claude Junker, State of the Union 2017[1]

1- **Introduction**

Negative externalities could be associated with cross-border financial problems either involving instability across European markets including the sovereign debt or systemically important European financial institutions with large cross-border operations and financial exposures. Against this backdrop, since the Global Financial Crisis (GFC), the euro area stepped up an iterative process aimed at internalising some of the potential negative externalities associated with the integration of national financial systems and made tangible progress to capture potential efficiency gains through policy coordination.[2]

Such policy coordination has always involved harmonisation in the EU. The Single Rule Book is regulatory harmonisation to the highest level, but it did not involve centralisation of decision-making structures. It was just part of the above mentioned iterative process, which culminated with centralisation of decision-making structures but only in the euro area countries: the Single Supervisory Mechanism, the Single Resolution Board and the commitment to complete the Banking Union.

---

[1] President Jean-Claude Juncker's State of the Union Address, 13 September 2017, Brussels, https://ec.europa.eu/commission/presscorner/detail/en/SPEECH_17_3165

[2] Maria Nieto and Garry Schinasi, 'EU Framework for Safeguarding Financial Stability: Towards an Analytical Benchmark for Assessing its Effectiveness' (2007) IMF Working Paper No. 07/260 <https://www.imf.org/en/Publications/WP/Issues/2016/12/31/EU-Framework-for-Safeguarding-Financial-Stability-Towards-an-Analytical-Benchmark-for-21429> accessed 10 September 2020; Martin Schmitz and Marcel Tirpak, 'Cross-border Banking in the Euro Area Since the Crisis: What is Driving the Great Retrenchment?' (2017) Financial Stability Review – Special features 145–157; Stijn Claessens and Neeltje Van Horen, 'Foreign banks: Trends and Impact' (2014) 46(1) Journal of Money, Credit & Banking 295–326; Gian-Maria Milesi-Ferretti and Cedric Tille, 'The Great Retrenchment: International Capital Flows During the Global Financial Crisis' (2010) Graduate Institute of International Studies Working Papers 18/2010 <http://repec.graduateinstitute.ch/pdfs/Working_papers/HEIDWP18-2010.pdf> accessed 10 September 2020; Marcus K Brunnermeier, 'Deciphering the Liquidity and Credit Crunch 2007–2008' (2009) 23(1) Journal of Economic Perspectives 77–100; Nicola Cetorelli and Linda S Goldberg, 'Global Banks and International Shock Transmission: Evidence from The Crisis (2019) NBER Working Paper No 15974 <http://www.nber.org/papers/w15974.pdf> accessed 25 February 2019

The GFC and the euro area sovereign crisis made clear that full internalisation of decisions and policies in safeguarding financial stability within the euro area could lead to welfare enhancing improvements relative to the existing European decentralised architectures and decision-making processes at the time of the crisis. However, the centralisation of the euro area safety net came hand in hand with the real separation of the geographical perimeters of the EU Single Rule Book, envisaged to guarantee the highest level of regulatory harmonisation as a mechanism of coordination in the EU, and the perimeter of the centralised euro area decision-making structures on supervision (ECB governing Council and Single Supervision Mechanism (SSM) and crisis management (Single Resolution Board).[3] Such separation raises a number of coordination problems, which have been partly dealt with by a rule based "close cooperation" mechanism of coordination between EU non-euro area NCAs and the ECB.

At present, the above mentioned "close cooperation" has been exercised by two countries: Bulgaria and Croatia. Both countries have small open economies that are strongly integrated with the euro area economy. Most foreign direct investments originate in the euro area and there is a high degree of synchronization of their GDP growth and their business cycles with those of the euro area.[4] Bulgaria and Croatia had their currencies closely tied to the euro at the time of applying to the ERM II in order to become full members of the euro area. Bulgaria maintained a currency board pegging the lev to the euro. Similarly, Croatian kuna had a peg to the Euro with a narrow band. In both cases this resulted in the loss of room for manoeuvre in their ability to freely exercise domestic monetary policy.

Focusing on the cases of Bulgaria and Croatia, this paper attempts to respond the following questions: What is the rationale behind the double requirement of having to simultaneously apply to become a member of the ERM II and to prepare to become a

[3] Henceforth, we will refer to both (Single Supervisory Mechanism and Single Resolution Board) as the Banking Union.

[4] Milan Deskar-Škrbic´ et al, 'The Third Round of Euro Area Enlargement: Are the Candidates Ready?' (2020) 107 Journal of International Money and Finance, 4; Victor Mendez-Barreira, 'The Eurozone's Eastern Conundrum' *Central Bank Magazine* (26 August 2020) <https://www.centralbanking.com/central-banks/monetary-policy/international/7671126/the-eurozones-eastern-conundrum> accessed 10 September 2020

member of the Banking Union via rule based “close cooperation” mechanism of coordination between the EU non-euro area NCAs and the ECB? Does the integration of close cooperation countries' banking systems with the euro area banking systems support the decision to join ERM II and ¨opting-in¨ to the SSM? Do the existing “close cooperation” arrangements guarantee greater coordination of resource-allocating decisions on prudential supervision and improved internalisation of financial stability decisions? What are the advantages of the preparation to become a full member of the euro area and the SSM (e.g. coordination of macro and microprudential regulation; coordination of microprudential supervision and bank resolution)?

This article is divided in five sections in addition to this introduction. Section 2 analyses the rationale of the double requirement to apply to become a member of the ERM II and to prepare to become a member of the Banking Union. Section 3 presents a characterisation of the two banking systems in the EU-non euro area countries that applied to join the ERM II - Bulgaria and Croatia -, including the importance of the presence of euro area banks. Section 4 analyses the cooperation in normal times during the “close cooperation” period. This is cooperation in microprudential and macroprudential supervision while fulfilling the nominal convergence criteria to join the monetary union. Section 5 analyses the cooperation in times of crisis when there is a need to resolve or liquidate a bank. In particular, the incentives to cooperate under those circumstances in the context of becoming a member of the monetary union. The final section offers some conclusions.

2- The duality of ERMII membership and entering close cooperation.

In the case of Bulgaria and Croatia, the Governing Council of the European Central Bank (ECB) has adopted a decision to establish close cooperation with their respective central banks following the fulfilment of the necessary supervisory and legislative prerequisites.In parallel, the inclusion of their respective currencies in the Exchange Rate Mechanism II was announced.[5]Together, these two steps pave the way for Bulgaria and Croatia's future participation in the euro area.[6]

"*This is the first time a Member State's national currency would join ERM II since the start of the EU banking union. Upon the introduction of the euro a Member State now also joins the banking union, which is irreversible and involves direct powers of the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) over its banking system. Therefore, participating in ERM II with a view to later adopting the euro also involves – for Bulgaria's [and Croatia] as well as for any other Member State's national currency that will in the future join ERM II – preparing for joining the banking union.*"[7]

---

[5] The central parities and the standard fluctuation bands of plus or minus 15% for both the Bulgarian Lev and the Croatian Kuna were agreed on July 10th 2020. See ECB press releases: 'Communiqué on Bulgaria' (20 July 2020) <https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200710~4aa5e3565a.en.html>; 'Communiqué on Croatia' (10 July 2020) <https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200710_1~88c0f764e7.en.html> accessed 10 September 2020. Following a careful assessment of the appropriateness and sustainability of Bulgaria's currency board, it was accepted that Bulgaria is joining the exchange rate mechanism with its existing currency board arrangement in place as a unilateral commitment, thus placing no additional obligations on the ECB.

[6] 'ECB Establishes Close Cooperation with Croatia´s Central Bank' Press release (10 July 2020) <https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200710_1~ead3942902.en.html> (accessed 30 July 2020); 'ECB Establishes Close Cooperation with Bulgaria´s Central Bank' Press release (10 July 2020) <https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200710~ae2abe1f23.en.html> accessed 30 July 2020. Starting from 1 October 2020, the ECB will be in charge of the direct supervision of the significant institutions in Croatia and Bulgaria and the common procedures for all supervised entities, as well as the oversight of less significant institutions. In the meantime, the ECB will carry out an assessment to determine which banks fulfil the criteria to be classified as significant institutions.

[7] See Annex 2, Common understanding of the commitments taken by Bulgaria as participating member in 'Ad-hoc Meeting of 12 July to Discuss the Prospects of Bulgaria Participating in the ERM II Mechanism' (Brussels, 24 July 2018) <https://www.consilium.europa.eu/media/36257/summing-up-letter-ad-hoc-meeting-erm-ii-12-july-2018.pdf> accessed 30 June 2020. The letter of the Euro group President explicitly states that "*In the future, we expect to follow a similar approach for Member States wishing to join ERM*

We should bear in mind that the requirement of joining the ERM II has been envisaged by the Treaty and policy makers as a transition stage aimed at ensuring that the Member State seeking to adopt the Euro can meet the principles of the ERM II, which are as follows:[8]

i) *"to ensure that Member States outside the euro area participating in the mechanism orient their policies to stability, foster convergence and thereby help them in their efforts to adopt the euro;*
ii) *[it] will provide a reference for their conduct of sound economic policies in general and monetary policy in particular and*
iii) *to protect non euro area Member States from unwarranted pressures in the foreign-exchange markets."*

Hence, participation in the ERM II is a precondition as well fulfilment of the nominal convergence criteria to join the euro and, as such, it is binding and of a temporary nature.[9]It should be noted that the currencies of Bulgaria and Croatia were already closely tied to the euro at the time of applying to the ERM II. Bulgaria had a currency board (first with the Deutsche Mark and after with the Euro since 1999) after a devastating debt and banking crisis in 1997. Croatia had a peg first with the Deutsche Mark and, since 1999, to the Euro with a narrow band. All the countries that joined the

II, in line with the principle of equal treatment." This was the case of Croatia that applied July 2019. European Central Bank, 'Opinion of the European Central Bank of 4 August 2017 on a Draft Decision on the Monetary Policy Implementation of Hrvatska Narodna Banka' (CON/2017/30) <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52017AB0030&from=EN> accessed 10 September 2020

[8] Articles 140-142 TFEU; Consolidated Version of the Treaty on the Functioning of the European Union Protocol (No. 13) on the Convergence Criteria [2016] OJ C202/8; Point 1.3 of Resolution on the European Council on the Establishment of an Exchange-rate Mechanism in the Third Stage of Economic and Monetary Union [1997] OJ C236/5, 5. Interinstitutional Agreement of 6 December 2013 between the European Central Bank and the National Central Banks of the Member States outside the Euro Area Amending the Agreement of 16 March 2006 between the European Central Bank and the National Central Banks of the Member States outside the Euro Area Laying Down the Operating Procedures for an Exchange Rate Mechanism in Stage Three of Economic and Monetary Union [2014] OJ C2014/C 17/01. See also René Smits, *The European Central Bank: Institutional Aspects* (Kluwer Law International 1997), 465-466. See also Chiara Zilioli and Martin Selmayr, *The Law of the European Central Bank*, (Hart Publishing 2004), 133-137. For a discussion about other Member States possibly entering close co-operation see Svend E Hougaard Jensen and Dirk Schoenmaker, 'Should Denmark and Sweden Join the Banking Union?' (2020) Journal of Financial Regulation

[9] Agreement of 16 March 2006 between the European Central Bank and the National Central Banks of the Member States outside the Euro Area Laying down the Operating Procedures for an Exchange Rate Mechanism in Stage Three of Economic and Monetary Union [2006] OJ C73/08

ERM have become members of the European Monetary Union (EMU)[10] with the only exception of Denmark. Denmark opted-out of the obligation to become member of EMU by virtue of Protocols No 15 and No 16, respectively.[11]

After the launch of the SSM as an integral part of the institutional architecture of the euro, it was rational that policy makers when joining the ERM II, would demand the obligation to simultaneously both join the ERM II and establish close cooperation between their respective central banks and the ECB following the fulfilment of the necessary supervisory and legislative prerequisites. The first was in preparation to become a member of the euro and the second to be a member of the Banking Union. In turn, the participation in the Banking Union requires a period of close cooperation with the ECB in the context of the "close cooperation" mechanism of coordination between EU non-euro area National Competent Authorities (NCAs) and the SSM.

The requirement of close cooperation, when applying to the ERM II deals with the 'efficiency' gaps in the pre-existing arrangements that neglected the possibility of negative bank sovereign "loops."[12] Against this background, as it is in the case for the ERM II, the "participation" mechanism should be understood as a binding requirement of temporary nature until the applying country joins the EMU.

In this context, the binding and temporary nature of the "close cooperation" mechanism highlights a particular case of the bespoke governance arrangements of Article 7 general governance arrangements of the SSM Regulation in which the possibility of "opting out" fades with the incentives for joining the euro.[13]Article 7 and its modalities (set out

---

[10] Since the inception of the euro the following Members States have joined the ERM II: Denmark and Greece (26 September 1998), Estonia, Slovenia and Lithuania (27 June 2004), Cyprus, Latvia and Malta (29 April 2005), Slovakia (25 November 2005). See ERM II Central Bank Agreement, ibid. See the list of amendment <https://www.ecb.europa.eu/ecb/legal/107663/1350/html/index.en.html> accessed 30 June 2020

[11] Council of the European Union, 'Opinion of the Legal Service: Legal assessment of the Conditions for Access to the ERM II Mechanism' JUR 386. ECOFIN 678. UEM 246 (Brussels, 26 June 2019)

[12] Maximilian Podstawski, and Anton Velinov, 'The State Dependent Impact of Bank Exposure on Sovereign Risk'(2018) 88 Journal of Banking & Finance 63. For a critique, See Adrian Dumitrescu-Pasecinic, 'The Constitutional Price for International Unilateralism in the European Banking Union' (2019) 38(1) Yearbook of European Law 320, 357-358

[13] The SSM was established by Council Regulation (EU) 1024/2013 of 15 October 2013 concerning specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions [2013] OJ L287, 63 (hereinafter referred to as SSM Regulation). Close cooperation in Regulation (EU) 468/2014 of the European Central Bank of 16 April 2014 establishing the framework for

primarily in the 2014 SSM Framework Regulation and the 2014 ECB Close Cooperation Decision) permit non-euro area Member States to participate in the SSM through a close cooperation arrangement.

3- **The features of the banking systems as a rationale for entering ¨close cooperation¨ under the SSM** [14]

The interconnection of the banking systems of Bulgaria and Croatia with the rest of the EU Member States creates incentives for "close cooperation" with the Banking Union.The higher the proportion of foreign banks to domestic banks the greater the need for cooperation and coordination to minimise the risks of contagion from cross-border banking. According to the ECB, a foreign bank is defined as 'controlled by either an EU or a non-EU parent that is "foreign" from the reporting country's point of view'.[15]

There are different drivers in respect of the number of foreign banks in a Member State such as the size of capital markets as a source of liquidity, historic liberalisation of financial markets to foreign competition, privatisation in the aftermath of banking crisis as it was in the case of Bulgaria, and, finally, the opportunity of foreign banks to play a dominant role in view of the limited size of domestic banks both in Bulgaria and Croatia.

The presence of those subsidiaries is partly answered by the historical takeovers of failing institutions in the market and the opportunity those markets present to the EU

---

cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities [2014] OJ L141, 1 (hereinafter referred to as SSM Framework Regulation), and Decision ECB/2014/5 of 31 January 2014 on close cooperation with the national competent authorities of participating Member States whose currency is not the euro [2014] OJ L198, 7

[14] Bulgaria became a member of the EU on 1st January 2007 and Croatia was the latest to join the EU on July 1st 2013.

[15] Definition of 'foreign banks': "Foreign banks are defined as subsidiaries and branches that are controlled by either an EU or a non-EU parent that is "foreign" from the reporting country's point of view. The data for these institutions are excluded from the data on the domestic banking sector and are aggregated under the heading "foreign banks". The fact that foreign banks account for a significant proportion of the domestic banking sector in some EU countries justifies their separate analysis." European Central Bank, 'Consolidated Banking Data' <https://www.ecb.europa.eu/stats/supervisory_prudential_statistics/consolidated_banking_data/html/index.en.html> accessed 28 February 2019

banks from Italy, France, Austria and Germany.[16] Table 1 shows the important presence of EU banks, mostly in the form of subsidiaries, in Bulgaria and Croatia.

[16] Ismael Ahmed Fontán et al, 'Banking Supervision and Resolution in The EU Effects On Small Host Countries In Central, Eastern And South Eastern Europe' World Bank Working Paper (April 2019) <http://pubdocs.worldbank.org/en/589991557325278014/FinSAC-BR-Effects-on-Small-Host-Countries-Europe.pdf> accessed 10 September 2020

Table 1: Total Number of Banks, Branches and Subsidiaries: Bulgaria and Croatia (2018)[17]

Country	Total Number of Banks	EU Branches	EU Subsidiaries	Non-EU Branches	Non-EU Subsidiaries
Bulgaria	26	3	10	2	3
Croatia	28	1	8	0	1

Source: ECB 2018

[17] European Central Bank, 'EU Structural Financial Indicators: End of 2019' Press release (8 June 2020) <https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200608~4613968937.en.html> accessed 30 June 2020

in the case of Bulgaria and Croatia, their banking systems are dominated by subsidiaries of euro area banks that together have a sizeable share of the market. As shown in Table 2, the ECB designated significant banks in Bulgaria represent 58.09% of total market share by assets and of this market share 76.43% is owned by euro area banks and 100% is foreign owned (euro area and the EU). Considering the country consolidated banking assets, the banking sector is relatively small in comparison to the country's GDP at 11% in Bulgaria and close to 13% in Croatia, which suggests the systemic risk exposure of the banking sector is comparatively limited. Although a disorderly bank crisis could well morph into a systemic crisis.

The Bulgarian banking system is less concentrated than the Croatian banking system, the likely result of the devastating banking crisis in Bulgaria in 1997. In Croatia, the ECB designated significant banks are all foreign subsidiaries of euro area banks. The total market share of the significant banks is 72.91% and of that 100% is owned by euro area banks. The proportion of total market assets of the top three significant banks in Bulgaria and Croatia is 42.76% and 53.61% respectively indicating their economic importance in the Member States. Equally, the relative size of consolidated banking assets per GDP is small, which suggests limited systemic risk of the banking system to the real economy.

Table 2: Banks included in the ECB list of banks directly supervised in Bulgaria and Croatia

Largest Commercial Banks including subsidiaries	Affiliate of euro-area bank	# Ranking by Assets (National)	Total Assets of Significant Banks (National Currency)	Total Asset Market Share	Country Consolidated Banking Assets 2018	Nominal GDP (National Currency) (2018)	Significant Banks´ Assets Share over GDP(2018)	Country Total Banking Assets / GDP (2018)
UNICREDIT BULBANK AD	Y (Unicredit Italy)	1	19,413,598	18.39%			1.96%	
DSK Bank Plc	N (OTP Bank PLC Hungary)	2	14,451,306	13.69%			1.46%	
UNITED BULGARIAN BANK - UBB	Y (KBC Belgium)	3	11,270,401	10.68%			1.14%	
Eurobank Bulgaria AD	Y (EUROBANK ERGASIAS SA Greece	5	8,207,481	7.78%			0.83%	
Raiffeisenbank (Bulgaria) EAD	Y (Raiffeisenbank Austria)	6	7,974,358	7.55%			0.81%	
			61,317,144	58.09%	10,555,661,901	99,000,000,000	6.19%	11%
ZAGREBACKA BANKA DD	Y (Unicredit SPA Italy)	1	113,243,331	23.56%			3.04%	
PRIVREDNA BANKA ZAGREB D.D	Y (Intesa Sanpaolo Italy)	2	83,023,299	17.27%			2.23%	
ERSTE & STEIERMARKISCHE BANK D	Y (Erste Group Bank AG Austria)	3	61,435,103	12.78%			1.65%	
RAIFFEISENBANK AUSTRIA D.D.	Y (Raiffeisenbank Austria)	5	32,624,575	10.14%			0.88%	
Addiko Bank d.d.	Y Addiko Bank AG Austria	8	18,380,256	5.17%			0.49%	
Sberbank d.d	Y (Sberbank Europe AG Austria)	9	9,639,177	2.99%			0.26%	
PBZ stambena štedionica d.d.	Y (Intesa Sanpaolo S.p.A. Italy)	15	1,949,022	0.60%			0.05%	
Raiffeisen stambena štedionica d.d	Y (Raiffeisenbank Austria)	26	1,223,224	0.40%			0.03%	
			321,517,987	72.91%	48,070,732,880	372,300,000,000	8.64%	12.91%

Source: Central Bank Data and IMF WEO (April, 2020)[18]

[18] Bulgarian National Bank, 'Banks in Bulgaria' (April-June 2018) <http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/pub_b_in_b_2018_06_en.pdf> accessed 10 September 2020; Croatia Central Bank, 'Banks Bulletin' (2019) Year 19, No. 32 <https://www.hnb.hr/documents/20182/2868711/ebilten-o-bankama-32.pdf/3a0e4fc0-e413-49da-2a9b-3c9fc0ff0b84> accessed 10 September 2020 ; International Monetary Fund, *World Economic Outlook: The Great Lockdown* (IMF 2020)

The criteria to assess if a credit institution will fall under the supervision of the ECB is set out in the SSMR.[19] The criteria specifically refers to size, importance for the Union or any participating Member State and finally significance of its cross-border activities. While there is further elaboration of the criteria in the SSMR it is not entirely complete with the ECB utilising its discretion to elaborate on the significance of banks by utilising other factors as well, as follows:

i. The total value of its assets exceeds €30 billion (neither Bulgaria or Croatia do have a banks of this size); or,

ii. The ratio of its total assets over the GDP of the participating Member State of establishment exceeds 20%, unless the total value of its assets is below €5 billion (none of the banks meet this criterion in Bulgaria nor in Croatia);

iii the cross-border exposures in terms of assets and liabilities: In view of the ECB anticipating directly supervising significant banking groups it has identified banks both in Bulgaria and Croatia that fall within this category; or,

iv. It is among the three most significant credit institutions in the participating Member State (see Table 2, The ECB has designated 3 banks in both Bulgaria and Croatia that fall in to this category which is in line with similar euro area Member States), unless justified by circumstances.

In the case of Croatia and Bulgaria, Criteria *(iii)* and (*iv)* seem to be the criteria used by the ECB to assess whether a bank will fall under the supervision of the ECB.[20] In comparison with other relatively small Member States, the use of criteria (*iv*) is not unusual. Although the ECB does not have directly applicable powers over supervised entities in Bulgaria and Croatia, the ECB is empowered to address specific and general "instructions" regarding approximately 58.09% of the banking market in Bulgaria and 72.91%of the banking market in Croatia (significant institutions) in terms of total assets as of December 2018.[21]

---

[19] Article 6(4)(i)-(iii).SSMR.

[20] ECB lists Bulgarian and Croatian banks it will directly supervise as of October 2020https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200911~882a53b229.en.html
(accessed 20th September 2020)

[21] Article 7(1) of SSM Regulation (n 12) and Article 107(3) of SSM Framework Regulation (n 12)

The ECB, however, exercised its discretion in accordance with Aricle 6(5)(b) of the SSMR to bring into direct supervision a number of less significant banks that operate in Bulgaria and Croatia.[22] In this category, the size of the bank in comparison o total assets is not the material factor for significance. It is useful to explore why a number of less significant banks have been brought under direct supervision. The decision of the ECB to exercise its discretion to classify less significant banks as significant has not been without controversy.[23] However, an assessment of the number of banks being classified as significant in accordance with Art. 6(5)b has been limited. According to the July 2020 list of significant banks the decision has been exercised only 6 times and in most of those instances the banks are US entities with multiple entities in the Euro Area.[24] It means Bulgaria and Croatia will have more significant banks, 5 and 8 respectively, than some of the larger Member States of the euro area.[25] Nevertheless, it is important to explore why some of those less significant banks are now classified as significant, which is not clarified by the ECB on a case by case basis. In respect of Bulgaria, Eurobank which is ranked 4th in terms of total assets is wholly owned by Eurobank Ergasias Services and Holdings S.A., which has assistance from the Hellenic Financial Stability Facility to support its restructuring and remains partially owned by the facility.[26] In view of this assistance, the ECB has the discretion to directly supervise Eurobank in Bulgaria in view of its significant business operations in the Member State. In respect of Adikko, originally a less significant bank, in Austria is now reclassified as a significant bank. As a result of this, its subsidiaries in Slovenia and Croatia, in view of their significance to the parent, are also classed in those Member States as significant

[22] Article 6(5)b of SSM Regulation (n12) and Article 67 SSM Framework Regulation (n12); ECB lists Bulgarian and Croatian banks it will
directly supervise as of October 2020, 11 September 2020.

[23] Argyro Karagianni and Miroslava Scholten, 'Accountability Gaps in the Single Supervisory Mechanism (SSM) Framework' 34(2) *Utrecht Journal of International and European Law* (2018) pp. 185–194; and more recently Filippo Annunziata, European Banking Supervision in the Age of the ECB: Landeskreditbank Baden-Württemberg—Förderbank v. ECB, 21, *European Business Organization Law Review* (2020) pp.545-570. See also Tobias Tröger, A political economy perspective on common supervision in the Eurozone, in Ester Faia et al, (eds) *Financial Regulation: A Transatlantic Perspective*, Cambridge: Cambridge University Press (2015) pp.167-192.

[24] ECB List of supervised entities, 1 July 2020.

[25] Whether this is a new policy direction of number of significant banks increase in accordance with Art. 6(5)(b) is beyond the scope of this paper.

[26] COMMISSION DECISION of 29.04.2014 ON THE STATE AID SA.34825 (2012/C), SA.34825 (2014/NN), SA.36006 (2013/NN) SA.34488 (2012/C) (ex 2012/NN) SA.31155 (2013/C) (2013/NN) (ex 2010/N) Implemented by Greece For the Eurobank Group related to:
https://ec.europa.eu/competition/state_aid/cases/248556/248556_1563415_75_3.pdf

banks.[27] Adikko was listed as a ‘other cross border group’ by the SRB so for the purposes of resolution fell within the responsibility for the purposes of resolution albeit a less significant bank for the purposes of the SSM.[28] In our view, the move to directly supervise Addiko AG group in Austria and its subsidiaries in Slovenia and Croatia highlights another important dimension to the ECB decision to extend significance to this entity so supervision aligns with the SRB decision to class such institutions as important from a cross border resolution perspective. This would also assist with centralising the preparation of recovery plans which fall within the responsibility of the supervisor.

4- The supervisory incentives to enter close cooperation

The two countries entering close cooperation depict a relationship common amongst relatively small Member States that see their banking system dominated by foreign banks from the larger Member States where the largest cross-border banks are parented. This top-down relationship between large and small gives rise to information asymmetry challenges that are common between such home and host authorities of different parts of a banking group.[29]

This is particularly important where entities reside in the host country that are critical to the host but not necessarily critical to the group - a critical area of research highlighted by Herring and more recently by Pistor.[30] In this relationship either the home or host can forebear timely sharing of information and, critically, decide whether to share the burden of financial support of distressed parts of the group only when it serves their

[27] While in Slovenia and Croatia the subsidiaries of Adikko bank mean they are ranked 10th and 8th by total assets the proportion of those of the group mean they are significant to the group.
[28] https://srb.europa.eu/en/content/banks-under-srbs-remit
[29] Richard Herring, ‘Conflicts between Home and Host Country Prudential Supervisors’ in Douglas Evanoff et al. (eds), *International Financial Stability: Global Banking and National Regulation* (World Scientific 2007), 201-220
[30] For a historical perspective see David Mayes and Jukka Vesala, ‘On the Problems of Home Country Control’ (1998) Bank of Finland Discussion Papers 20/98; For a more recent perspective see Katharina Pistor, ‘Host’s Dilemma: Rethinking EU Banking Regulation in Light of the Global Crisis’ (2010) ECGI Working Paper Series in Finance No 286/2010; see also Katia D’Hulster, ‘Cross-border Banking Supervision: Incentive Conflicts in Supervisory Information Sharing between Home and Host Supervisors’ (2011) 13(4) Journal of Banking Regulation; Guido Ferrarini and Luigi Chiarella, ‘Common Banking Supervision in the Eurozone: Strengths and Weaknesses’ ECGI Working Paper No 223/2013 (August 2013), 6–10; see also, Emilios Avgouleas, *Governance of Global Financial Markets: The Law, the Economics, the Politics* (Cambridge University Press 2012), 422–423

self-interest. Therefore, an acute challenge for small hosts is to experience a scenario where their limited importance to the group means they are often neglected due to their poor bargaining power. The requirement to enter close cooperation attempts to address such matters. It is now evident the relationship in the banking union is one that is comparable rather than equivalent to their eurozone counterparts.[31]

In both Bulgaria and Croatia significant domestic legislative reforms have been implemented to ensure the transfer of administrative jurisdiction over supervision and resolution decision-making.[32] In this relationship, the “close cooperation” countries implement legislation to share the responsibility of supervision and resolution with the ECB and SRB. The decisions made by the ECB and SRB require the domestic competent authorities and resolution authorities to execute those decisions. In this respect, the ECB does not have direct supervision of significant banks as it does with significant banks in eurozone Member States.

The ECB will instruct the Bulgarian and Croatian central banks as prudential supervisors both in terms of microprudential supervision and, in part, macroprudential supervision.[33] The latter is primarily within the discretion of the Bulgarian and Croatian

[31] Dalvinder Singh, *European Cross Border Banking and Banking Supervision* (Oxford University Press 2020), 33

[32] European Central Bank, ‘Opinion of the European Central Bank of 27 November 2017 on amendments to the decision making framework of Българска народна банка (Bulgarian National Bank) (CON/2017/51)’ <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52017AB0051&rid=1> accessed 10 September 2020

[33] Article 108 (1)-(5) of SSM Framework Regulation (n 12); European Central Bank, ‘Opinion of the European Central Bank of 16 November 2018 on the implementation of the recommendations of the convergence report into the Law on Българска народна банка (Bulgarian National Bank) (CON/2018/53)’ <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52018AB0053> accessed 10 September 2020; European Central Bank, ‘Opinion of the European Central Bank of 17 December 2019 on payment services and payment systems (CON/2019/45)’ <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52019AB0045> accessed 10 September 2020; European Central Bank, ‘Opinion of the European Central Bank of 30 January 2020 on the sanctioning powers of BNB within close cooperation and the official exchange rate of the Bulgarian lev (CON/2020/5)’ <https://op.europa.eu/en/publication-detail/-/publication/d677b36f-4678-11ea-b81b-01aa75ed71a1/language-de> accessed 10 September 2020. European Central Bank, ‘Opinion of the European Central Bank of 8 July 2019 on national legislation to be adopted for the purpose of establishing close cooperation between the European Central Bank and Hrvatska narodna banka (CON/2019/25)’ <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52019AB0025> accessed 10 September 2020; European Central Bank, ‘Opinion of the European Central Bank of 18 March 2020 on Hrvatska narodna banka (CON/2020/8)’ <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52020AB0008> (accessed 10 September 2020)

national banks but will now be open to scrutiny by the ECB who may request to adopt or increase levels of capital and liquidity for the purposes of macro-prudential risks.[34] Article 7 provides the ECB the authority to change macroprudential capital buffers but the National Designated Authority (NDA) retains the authority to decide which banks are designated O-SII's. In order for the ECB to fulfil its task, the Bulgarian and Croatian central banks are expected to provide data and documents, access to accounting records and oral and written explanations.

The SSM Regulation, particularly Articles 4(1) and (2) on supervision, Article 5 concerning macroprudential action and Article 6 detailing the allocation of tasks between the ECB and NCAs as well as criteria for designating banks as significant, and the 2014 SSM Cooperation Framework constitute the legal framework in which coordination between the ECB and the non-euro area participating Member States takes place. This framework defines the 'in-direct' authority of the ECB over the supervised entities, while exercises a direct authority over the NCAs and NDAs;[35] the buttressing techniques of the ECB authority; the deterrence mechanisms of the ECB to back its authority; the safeguards of the non-euro area Member States who lack the representation in the decision-making bodies of the ECB, in particular the Governing Council, and, last but not least, the termination of the close cooperation arrangement.[36]

When a close cooperation arrangement is in place, the ECB decisions addressed to significant supervised entities and less significant supervised entities are replaced by instructions to NCAs and the NDAs.[37] NCAs then adopt national administrative measures or otherwise execute the ECB´s instructions. As Moloney describes it, the ECB decision making is therefore intermediated.[38] The cooperation arrangement being a

---

On 24 June 2020 the Governing Council adopted Decision (EU) 2020/1015 on the establishment of close cooperation between the European Central Bank and Българска народна банка (Bulgarian National Bank) (ECB/2020/30) and Decision (EU) 2020/1016 on the establishment of close cooperation between the European Central Bank and Hrvatska Narodna Banka (ECB/2020/31).

[34] Article 5 of SSM Regulation (n 12)

[35] Article 107(2) of SSM Framework Regulation (n 12).

[36]Articles 7(5)–(8) SSM Regulation (n12); Article 6 of Decision ECB/2014/5 (n 12); and Articles 118–119 of SSM Framework Regulation (n 12).

[37] Article 108 of SSM Framework Regulation (n 12).

[38] Niamh Moloney, 'Close Cooperation: the SSM Institutional Framework and Lessons from the ESAs' (ECB Legal Conference, Frankfurt, December 2019)

precondition to join the euro, economic incentives are fully aligned to develop a good working relationship between the ECB and the central banks as prudential supervisory authorities of Bulgaria and Croatia. Not only reputational factors and the risks of exiting the cooperation, derived of the absence of arrangements for orderly withdrawal in the SSM Framework Regulation, minimise the authority risk of the ECB but also the commitment to join Monetary Union. [39]

The issues related to the lack of representation of the central banks as prudential supervisory authorities entering into close cooperation with the ECB in the decision-making structures of the ECB (Supervisory Board and the Governing Council) have been dealt with in the ECB Decision on the establishment of close cooperation between the ECB and the central banks of Bulgaria and Croatia: [40] Namely, (i) A representative of each of the central banks as prudential supervisory authority will participate and exercise voting rights in the Supervisory Board and (ii) the central bank representative to the Supervisory Board shall participate and exercise voting rights in the deliberations for the adoption by the ECB of instructions with regard to the identification of significant supervised entities established in their countries pursuant to Article 110 of Regulation (EU) No 468/2014 (ECB/2014/17).

Furthermore, the central banks of Croatia and Bulgaria will be full members of the ECB Governing Council once they meet the requirements to join the EMU. [41]The benefits of the close cooperation arrangement and the following participation in the SSM are several and constitute an important incentive to align their supervisory practices with the ECB and to develop a good working relationship between the ECB and the NCAs of Bulgaria and Croatia. Both countries are aligning their supervisory practices to the highest standards. Indeed, the ECB can be considered *de facto* a standard setter.[42]

---

[39] The termination of the close cooperation takes place also by means of an ECB decision. The ECB shall indicate the date from which it applies within a maximum period of three months, taking due consideration of supervisory effectiveness and legitimate interests of credit institutions. Therefore, there is a minimum arrangement aiming at ensuring an orderly withdrawal. The authors thank Adrian Dumitrescu for bringing this point to their attention.

[40] Decision (EU) 2020/1015 (n 23) and Decision (EU) 2020/1016 (n 23)

[41] This is different from the close cooperation when the countries have also applied to the ERM II as it is the case with Croatia and Bulgaria.

[42] Zsolt Darvas and Guntram Wolf, 'Should Non-Euro Area Countries Join the Single Supervisory Mechanism?' (2013) Brueguel Policy Contribution Issue 2013/06. See also, Ansgar Belke et al, '(When) Should a Non-Euro Country Join the Banking Union?' (2016) 14 Journal of Economic Asymmetries, 4;

The applicant Member State benefits from the access to supervisory expertise of Joint Supervisory Teams (JSTs), thus essentially hiring the credibility of the SSM.[43] The credibility of the NCAs will be boosted alongside the reputation of their banking systems.[44] The SSM also deals effectively with the asymmetries of information between the home and host countries and the incentives to reveal the true financial condition of the bank. Joint Supervisory Teams (JSTs) are the vehicle for the exchange of information and coordination among NCAs and the ECB both in the realms of prudential regulation and supervision. This is particularly relevant in the case of the banking systems dominated by subsidiaries of euro area banks. Moreover, the JSTs, which are always headed by the SSM staff, contribute to further buttress the ECB authority. Finally, the SSM is broad in scope and also very large in size and this allows it to exploit economies of scale with regard to expert knowledge.[45]

Table 3 conveys the idea of the complexity of the prudential regulatory frameworks and the need for coordination between the home and host countries.[46]

Table 3: Macroprudential Measures: Croatia and Bulgaria

Zdenek Kudrna, 'Governing the Ins and Outs of the EU's Banking Union' (2016) 17 Journal of Banking Regulation 119; Katalin Mérő and Dóra Piroska, 'Banking Union and Banking Nationalism – Explaining Opt-Out Choices of Hungary, Poland and the Czech Republic' (2016) 35 Journal Policy and Society 215; Krystyna Mitręga-Niestrój and Blandyna Puszer, 'The Threats of the Banking Union for the Polish Banking Sector', *European Financial Systems 2015: Proceedings of the 12th International Scientific Conference* (Masarykova Univerzita 2015), 400–07; Uwe Vollmer, 'The Asymmetric Implementation of the European Banking Union (EBU): Consequences for Financial Stability' (2016) International Journal of Management and Economics 7

[43] Rosa Lastra, 'Close Cooperation in the SSM' (ECB Legal Conference, Frankfurt, December 2019)

[44] Andrea Ernia, 'The Institution of "Close Cooperation" in the SSM: An Introduction' (ECB Legal Conference, Frankfurt, December 2019)

[45] ibid.

[46] European Central Bank, 'Opinion of the European Central Bank of 19 November 2018 on the macroprudential mandate of Българска народна банка (Bulgarian National Bank) and the governance of credit institutions (CON/2018/52)' <https://eur-lex.europa.eu/legal-content/PL/TXT/?uri=CELEX:52018AB0052> accessed 10 September 2020. European Central Bank, 'Opinion of the European Central Bank of 25 March 2020 on close cooperation between the European Central Bank and Hrvatska narodna banka (HNB) within the Single Supervisory Mechanism, and on the macroprudential mandate and tools of HNB (CON/2020/10)' <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52020AB0010> accessed 10 September 2020

Source: Authors' analysis

EU Non-euro area country	Largest Commercial Banks including subsidiaries	Affiliate of euro-area bank	**GSIB/O-SIB** (appliable **home country**, *anouncement dates*)	**O-SIB** (appliable **host country**, *anouncement dates*)	**CCyB** *(Application Dates)*	**Systemic Risk Buffers (SRB) There is no maximum limit for this buffer, but depending on its level and the impact on other Member States, authorisation from the European Commission may be required**		**Mandatory or voluntary reciprocity of foreign macroprudential measures according to recommendation ESRB/2015/2**	
			O-SII not subject to reciprocity		**Affected by the rate where exposures are located**	**Subject to reciptrocity CRD Art 133**	**SRB Reciptrocity by host**	**Macropru Measure**	**Mandatory Reciprocity**
Bulgaria	UNICREDIT BULBANK AD	Y (Unicredit **Italy**)	**G-SIB** Unicredit: 1% *(12/2019)*	Unicredit Bulbank: 1%(01/2020) *(11/2019)*	**Bulgaria**: 0.5% (10/2019) to 1% (04/2020) to 1.5% (01/2021) to 0,5% (04/2020)	Italy (None)	NA	Italy (None)	NA
	DSK Bank Plc	N (OTP Bank PLC **Hungary**)	OTP Bank: 2% *(01/2020)*	DSK Bank: 1% (01/2020)*(11/2019)*		Hungary (None)	NA	Hungary (None)	NA
	UNITED BULGARIAN BANK - UBB	Y (KBC **Belgium**)	KBC: 1.5% (*12/2019*)	United Bulgarian: 1% (01/2020) *(11/2019)*		Belgium (None)	NA	Belgium: RW add-on for: 1) retail exposures secured by residential immovable property located in Bel, composed of: (a) RW add-on of 5 pp; and (b) proportionate IRB RW add-on consisting of 33 % of the exposure-weighted avg of the RW .	Y
	Raifgeissen Bulgaria	Y (Raiffeisen Bank **Austria**)	Raiffeisenbank Bank Int´l: 2% *(01/2020)*	Raiffeisenbank Bulgaria: 0.75% (01/2020)*(11/2019)*		Austria (2% All Exposures)	Applicable	Austria (None)	NA
	Eurobank Bulgaria AD	Y (EUROBANK ERGASIAS SA **Greece**)	Eurobank Ergasias: 0.25% (01/19), 0,5 (01/20), 0.75(01/21), 0.75(01/22)	Eurobank Bulgaria: 0.75% (01/2020) *(11/2019)*		Greece (None)	NA	Greece (None)	NA
Croatia	ZAGREBACKA BANKA DD	Y(Unicredit SPA **Italy**)	**G-SIB** Unicredit: 1% *(12/2019)*	Unicredit: 2% *(12/2019)*	**Croatia**: None	Italy (None)	NA	Italy (None)	NA
	PRIVREDNA BANKA ZAGREB D.D	Y(Intesa Sanpaolo **Italy**)	Intesa Sanpaolo: 0.56% (1/20), 0.75%(1/21) (*11/2019*)	Privredna Banka: 2% *(12/2019)*		Italy (None)	NA	Italy (None)	NA
	ERSTE & STEIERMARKISCHE BANK DD	Y(Erste Group Bank AG **Austria**)	Erste Group Bank: 2% *(01/2020)*	Erste & S Bank: 2% *(01/2020)*		Austria (2% All Exposures)	Applicable	Austria (None)	NA
	RAIFFEISENBANK AUSTRIA D.D.	Y (Raiffeisen Bank **Austria**)	Raiffeisen Bank Int´l: 2% (01/2020)	Raiffeisen Bank Zagreb: *2% (01/2020)*		Austria (2% All Exposures)	Applicable	Austria (None)	NA
	Raiffeisen stambena štedionica d.d.	Y (Raiffeisen Bank **Austria**)	Raiffeisen Bank Int´l: 2% (01/2020)	NA		Austria (2% All Exposures)	Applicable	Austria (None)	NA
	Adiko Bank d.d.	Y(AI LAKE s.a.r.l.,**Luxemburg**)	NA	Adiko Bank d.d. 1% *(01/2020)*		Luxemburg NA	NA	Luxemburg (None)	NA
	Sberbank d.d.	Y (Sberbank Europe AG **Austria**)	NA	NA		Austria (1% All Exposures)	Applicable	Austria (None)	NA
	PBZ Stambena Stedinoca dd	Y(Intesa Sanpaolo S.p.A.**Italy**)	Intesa Sanpaolo: 0.56% (1/20), 0.75%(1/21) (11/2019)	NA		Italy (None)	NA	Italy (None)	NA

Table 3, shows both Bulgaria and Croatia generally classify the EU bank subsidiaries as O-SII's and the capital buffer rate they are expected to build up. The exceptions are in Croatia where Raiffeisen stambena štedionica d.d.-Croatia- and PBZ Stambena Stedinoca dd are not designated as O-SIIs in spite that their parents Raiffesen Bank International and Intesa Sanpaolo respectively are O-SIIs in their home country. Also, Adiko Bank d.d. is designated as O-SII by the Croatian authorities even if it is not by the home supervisor (Luxemburg). As explained earlier, both Member States have designated a large proportion of their banks as systemically important from a domestic perspective. It shows the O-SII criteria utilises an approach that focuses on the domestic systemic implications by assessing the extent a bank's business activities are substitutable and the level of interconnectedness within the market.

The banks designated by Bulgaria as O-SII's are also classified as O-SII's in the ultimate parent Member States. For example, in Bulgaria Unicredit Bulbank AD, United Bulgarian Bank and Raiffeisenbank Austria DD are designated an G-SIB or O-SII and so is the parent Unicredit SPA (G-SIB), KBC and Raiffeisenbank (O-SIIs) in Italy, Belgium and Austria respectively. In the case of Croatia, Zagrebacka Banka DD, Privredna Banka Zagreb D.D, Erste & Steiermarkische Bank DD are designated as G-SIB or O-SII and so is the parent Unicredit SPA (G-SIB), Intesa Sanpaolo and Erste Group Bank (O-SIIs) in Italy and Austria respectively. The Capital Requirement Directive (CRD IV)[47] enables Member States to reciprocate with respect to macroprudential requirements to minimise the distorting effects such requirements could have on the competitiveness of banks located in other Member States. Currently, none of the other EU Member States with the exception of Austria - where the ultimate parent resides have taken reciprocal measures to either increase or reduce the capital buffer rates.

[47] Article 135 of Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, 135 (hereinafter referred to as CRD IV); For the powers of the ESRB to recommend reciprocity, see: ESRB, *The ESRB Handbook on Operationalising Macroprudential Policy in the Banking Sector* (European Systemic Risk Board 2018), 48; The reported rate in Table 3 is the rate applied to domestic exposures, the effective bank-specific rates may differ. The SRB is cumulated to the higher of the O-SII and G-SII buffers, in line with Art. 133(5) CRD IV. <https://www.esrb.europa.eu/pub/pdf/other/esrb.handbook_mp180115.en.pdf> accessed 30 June 2020

5- The crisis management incentives for entering in close cooperation

The move towards centralisation of decision making in bank crisis resolution and mechanisms of financial support based on mutualisation of funding are important incentives for entering close cooperation to minimise the home and host dilemma associated to the asymmetry of information and the need to align incentives among safety net regulators**.** In the SRM, those entering close cooperation will see a shift in decision making about resolution from the national resolution authority to the Single Resolution Board (SRB) with the practical execution of the resolution scheme residing with the national resolution authority**.**[48] As it is the case with the EU Members, Member States in close cooperation retain critical responsibilities for emergency liquidity assistance and precautionary recapitalisation of solvent banks that are exposed to short term liquidity and capital assistance needs.[49]

These responsibilities reside at the national level regardless of whether a Member State is in close cooperation or fully-fledged member of the eurozone. A critical feature has been the move towards mutualisation of assistance through the Single Resolution Fund (SRF)**.**[50] In this respect, those entering close cooperation are required to introduce legislation to formally mutualise their national fund with the other participating Member States that are already members of the EMU. The move towards the Single Deposit Insurance Scheme (EDIS) will also be of benefit to those entering close cooperation but EDIS does not exist yet**.**

The most debatable aspect of close cooperation is likely to be in the field of resolution decision making.[51] The ECB decides for significant banks whether it is failing or likely to fail and the SRB decides how the bank will be resolved either in resolution or

[48] European Central Bank, 'Opinion of the European Central Bank of 17 April 2019 on participation in the Single Resolution Mechanism (CON/2019/16)' <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52019AB0016> accessed 10 September 2020

[49] Precautionary recapitalisation in Article 32(4) of European Parliament and Council Directive 2014/59/EU of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council (hereinafter referred to as BRRD) and emergency liquidity assistance in Article 31

[50] Opinion of the European Central Bank (CON/2019/16) (n 39)

[51] Jens-Hinrich Binder, 'Participation of Non-Euro Area Member States in the SRM: Centralized Decision-making, Decentralized Implementation – Shared responsibilities' (ECB Legal Conference, Frankfurt, December 2019) 314-330

insolvency- liquidation.[52] Consequently, this relocates decision making away from the NCAs of the respective Member States. The recent EBA mediation decision between the SRB and Romania illustrates the vulnerability of small hosts and the perception of bank operations that exist in their respective markets.[53] The redacted public statement highlights the disagreement on how different parts of the group and how entities within the group were likely to be resolved and the implications for the host Romania of those choices.

The resolution cases decided by the SRB so far point out that the public interest test for resolution strategy is interpreted differently in comparison to national interpretations of public interest thresholds, leading to a decision that the national authorities may not have taken, if they were responsible for making it. The encompassing approach followed by the ECB on the decision on the banks supervised by the ECB under the close cooperation in Bulgaria and Croatia seemingly limits this problem because it includes banks that have relevant cross border activity even though are less significant. This can be attributed to the actuality that SRB internalises the negative externalities beyond the national border that national authorities do not necessarily take into consideration. The national authorities may follow a narrower and domestically driven approach to ensure the continuity of critical functions. On the other hand, the SRB may not consider these functions as critical to the real economy and thus after its assessment decide that national insolvency law can be used to liquidate the bank and orchestrate a pay-out for insured deposits.

The evidence from recent cases decided by the SRB appears to suggest an outcomes-based approach that favours the national insolvency – liquidation proceedings, which may include special administrative actions to safeguard depositor interests. The outcomes of two sets of decisions in Italy and Croatia illustrate this position, therefore also highlighting the concern raised by Enria of a two-track public interest set of criteria

---

[52] Article 18(1) of Regulation (EU) 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010 (hereinafter referred to as SRM Regulation)

[53] European Banking Authority, 'Decision on the Settlement of a Disagreement, Addressed to: Single Resolution Board and Banca Naţională a României 2017 joint decision on group resolution plans and resolvability for [...]' (27 April 2018)

operating at the eurozone and Member State levels.[54] However, it is important to note that this is a challenge of the Banking Union per se and not one linked to entering close cooperation.

In the instance of the SRB decision relating to the Italian regional banks Veneto Banca and Banca Populare di Vicenza,[55] they were resolved using the Italian Special Administrative regime as opposed to the formal resolution envisaged in the Bank Recovery and Resolution Directive (BRRD) because their regional importance was considered not a threat to Italy's real economy. The SRB's mandate under the Single Resolution Mechanism Regulation (SRMR) requires to consider any regional and/or national threat to financial stability.National authorities are likely to assess sub-regional impacts as well, which in some respects the SRB had already done but considered it to be manageable for the Veneto Banca and Banca Populare di Vicenza in the Veneto region. It is notable that the Croatian authorities[56] took the opposite view when faced with a bank failing and its potential impact at the sub-regional level.

Following the resolution decision of Jadranska Banka d.d**.** Šibenik **(**€ 300m in assets and below 1% of total share market in Croatia**)**, although, from a regional perspective, it accounted for 34% of total deposits and 50% of finance to the region business sector,

---

[54] '[...] "The Commission said rules have been strictly applied. And I am convinced this is the case, but some questions remain and might have to be looked at in more detail when the dust settles," he said. "The decision that there was no EU public interest at stake in the crises of two ECB-supervised banks that were hoping to merge and operate in the same region with combined activities of around €60 billion sets the bar for resolution very high"'. Silvia Sciorill Borrelli, 'Europe's Top Bank Watchdog Makes Case for Optimism' *Politico* (London, 7 May 2017) <https://www.politico.eu/article/europes-top-bank-watchdog-makes-case-for-optimism/> accessed 13 June 2019

[55] Decision concerning the assessment of the conditions for resolution in respect of Veneto Banca SpA, Commission Decision SRB/EES/2017/11 [2017] OJ C242/2; Decision concerning the assessment of the conditions for resolution in respect of Banca Popolare di Vicenza SpA (2017/C 242/03); Decision of the Single Resolution Board in its Executive Session of 23 June 2017 concerning the assessment of the conditions for resolution in respect of Veneto Banca S.p.A. (the "Institution"), with the Legal Entity Identifier 549300W9STRUCJ2DLU64, addressed to Banca d'Italia in its capacity as National Resolution Authority SRB/EES/2017/11 <https://srb.europa.eu/sites/srbsite/files/srb-ees-2017-11_non-confidential.pdf> accessed 30 June 2020; Decision of the Single Resolution Board in its Executive Session of 23 June 2017 concerning the assessment of the conditions for resolution in respect of Banca Popolare di Vicenza S.p.A. (the "Institution"), with the Legal Entity Identifier V3AFM0G2D3A6E0QWDG59, addressed to Banca d'Italia in its capacity as National Resolution Authority SRB/EES/2017/12 <https://srb.europa.eu/sites/srbsite/files/srb-ees-2017-12_non-confidential.pdf> accessed 10 September 2020

[56] European Banking Authority, 'Notification of Resolution Decisions to the EBA' (9 October 2015) <https://eba.europa.eu/documents/10180/1227439/Letter+to+the+EBA.pdf> accessed 13 June 2019

while operating over half the cash machines. The case raises an interesting question of what would the SRB have decided in such circumstances - would the SRB adopt the same decision? In short, the assessment would be based on the potential outcomes of exercising Croatian insolvency proceedings in regard to safeguarding depositors. In this case, the national interest would likely be overridden by the SRB. In view of previous experience, it is doubtful the SRB would have opted for resolution despite the significant sub-regional footprint. The sale of parts of the business was probably an option to ensure access to ATM machines in the region, therefore, the resolution plan would have reflected the continuity of the critical service and its transfer to competitor.

The composition of the foreign banks in Bulgaria and Croatia shows a significant preponderance to the establishment of subsidiaries rather than branches as shown in Table 1. This is a unique feature of Eastern European banking systems.[57] Nevertheless, from the Deposit Guarantee Scheme (DGS) perspective, potentially more risk is generated by branches reliant on the home country to reimburse the depositors of the branch, with the host DGS providing “top up”. In view of this, the DGS reforms have attempted to articulate the arrangements to ensure this is executed efficiently. The level of confidence in the deposit guarantee scheme of any banking system relies on a variety of factors, with the level of pre-existing funds for covering depositor reimbursements being the principle element.[58] The Deposit Guarantee Scheme Directive (DGSD) expects Member States to have in place a target level fund of 0.8% of covered deposits and in exceptional cases it can be as low as 0.5%. The IADI highlights that a target level of 1.15% was proposed, however this met opposition based on the view that resolution techniques and the resolution fund would reduce the burden on the DGS.
In the case of Bulgaria and Croatia, both have opted for much higher target levels of 1.00% (Bulgaria) and 2.50% (Croatia) of covered deposits and, more importantly, Croatia has achieved the funding level and Bulgaria is only just below the target level.[59] In these cases it must be a precautionary sign of the likely use of the DGS fund, yet it also entails prudence exercised by the countries.

[57] Singh (n 21) 273.
[58] See European Banking Authority, ‘Deposit Guarantee Schemes Data’ <https://eba.europa.eu/regulation-and-policy/recovery-and-resolution/deposit-guarantee-schemes-data> accessed 13 July 2020

[59] Singh (n 21) 273.

In Bulgaria, the Bulgarian National bank is the resolution authority and the DGS has responsibilities akin to those of a 'pay box plus' with functions in resolution including managing the deposit insurance fund and the bank resolution fund as well as appointing trustees in bank bankruptcy.[60] In Croatia, the Croatian National Bank decides whether a bank enters resolution and the State Agency for Deposit Insurance and Bank Resolution is responsible for initiating a 'loss minimising' resolution strategy. See Table 4 for a comparison of the euro area safety net and the safety nets of Bulgaria and Croatia.

[60] IADI, 'Deposit Insurers' Role in Contingency Planning and System-wide Crisis Preparedness and Management' Guidance Paper (May 2019) <https://www.iadi.org/en/assets/File/Papers/Approved%20Guidance%20Papers/IADI%20Guidance%20Paper_DI%20role%20in%20contingency%20planning%20&%20crisis%20management.pdf> acessed 30 July 2020

Table 4: **Comparison of safety nets**

Safety Net Characteristics	Euro Area	Croatia	Bulgaria
Resolution	SRB / SRF (no liquidation)	NCB decides on resolution[61] DGS	NCB specify the requirements and processes of preparation and approval of recovery plans[62] DGS
DGS	Decentralized (some w/ resolution powers) and harmonization by Directive Recast 2014 planned EDIS	DGS resolution powers (loss minimising harmonized by Directive Recast 2014)	DGS resolution powers paybox box plus harmonized by Directive Recast 2014
Emergency Lending Facility	NCBs (ECB, Agreement on ELA, 17th May, 2017)	Central Bank of Croatia	Central Bank of Bulgaria (within the limits of its FX holdings)

Source**:** Authors´ analysis

[61] Central Bank of Croatia, 'Credit Institutions Resolvability Assessment Office Assesses the Feasibility and Credibility of Resolution of Credit Institutions that Experience Financial Difficulties' <https://www.hnb.hr/about-us/functions-and-structure/organisation> (accessed 30 June 2020)

[62] According to Article 16.16 of Law on the Bulgarian National Bank, Bank Resolution Directorate is to specify the requirements and processes of preparation and approval of recovery plans and to set up rules and procedures for early intervention. See Bulgarian National Bank, 'Law on the Bulgarian National Bank' <http://www.bnb.bg/bnbweb/groups/public/documents/bnb_law/laws_bnb_en.pdf>; Bulgarian National Bank, 'Annul Review of the Implementation of the Plan on Reforms and Development of Banking Supervision' <http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/p_np_bs_development_report_en.pdf> accessed 30 June 2020

The proportion of EU bank subsidiaries in both Bulgaria and Croatia is significantly higher in comparison to other EU Member States where a branch-based model is prevalent. This is despite the incentives the single passporting regime provides for the adoption of a branch-based model. In the case of branches, the recast 2014 DGS Directive[63] expects Member State DGSs to work together when a cross-border bank fails. The home country DGS is still expected to cover branch depositors in the host Member States. The host DGS is expected to make repayments according to the home country DGS's instructions. The home DGS can also request financial assistance from the host DGS to orchestrate a pay-out. The cooperation arrangement between the hosts´ supervisors and the ECB would be supportive of the cooperation agreement between home and host DGSs to the extent that potential losses and liquidity needs of the DGS in Croatia and Bulgaria will be minimised by the limitation of information asymmetries and the prudential supervisory practices at the highest standards.

The beneficiary of the ESM financial support must be an euro area sovereign that can receive assistance in any of the following ways: (1) precautionary financial assistance in the form of a precautionary conditioned credit line or enhanced conditions credit lines; (2) loans or; (3) financial assistance (loans) for the re-capitalisation of financial institutions (i.e. no direct bank capitalisations).[64] It is evident that the arrangements require for better supervision, resolution and deposit protection to be in place. It could be argued that a bank crisis may require the home country to request assistance from the ESM for the group as whole that may emanate from a financial problem in the host country in close cooperation. In this case, the home country and the group are the chief beneficiaries but it is likely to benefit the host as well since the measures may contain the negative spillover effects arising from the group failing.

---

[63] European Parliament and Council Directive 2014/49/EU of 16 April 2014 on deposit guarantee schemes [2014] OJ L173/149

[64] European Stability Mechanism, Treaty Establishing the European Stability Mechanism between the Kingdom of Belgium, the Federal Republic of Germany, the Republic of Estonia, Ireland, the Hellenic Republic, the Kingdom of Spain, the French Republic, the Italian Republic, the Republic of Cyprus, the Republic of Latvia, the Republic of Lithuania, the Grand Duchy of Luxembourg, Malta, the Kingdom of the Netherlands, the Republic of Austria, the Portuguese Republic, the Republic of Slovenia, the Slovak Republic and the Republic of Finland. Treaty <https://www.esm.europa.eu/sites/default/files/20150203_-_esm_treaty_-_en.pdf> accessed 4 June 2020. In the case of Spain, it was the first time the instrument of recapitalization of banks through loans granted to a government was used. There were no contributions from other lenders.

6- Conclusion

This paper seeks to assess the incentives of entering close cooperation for countries that are also applying to become members of the EMU - Bulgaria and Croatia - by looking at three key areas: the duality of ERMII membership and entering close-cooperation, the supervisory incentives, and the crisis management incentives for entering in close cooperation.

The expectation of entry in to the ERM and later the adoption of euro as a precursor to the Banking Union was not originally expressed in the SSMR. Nonetheless, the aspiration of ultimately joining the euro is crucial, perhaps in line with Juncker's, State of the Union address, with the simultaneous entry into the ERM II and close cooperation with the ECB being an important contributing factor to ensure the full benefits of simultaneous economic, financial and supervisory coordination. It is evident from the research undertaken in this paper that there are clear benefits from close cooperation for the respective Member States whose domestic currencies are already linked to the euro in view of the dominant position eurozone banks have in their respective domestic markets.

The strictness of the significance criteria does not lead to a potential position that only the top three banks fall within its remit in view of the ECB list of Bulgarian and Croatian banks that it will supervise as October 2020. The ECB encompassing approach seems to consider not only the domestic systemic importance of banks but also the importance of their cross-border operations. Against this background, a significant proportion of total assets of their banking systems in Bulgaria and Croatia 58.09% and 73% respectively is brought under centralised supervision and resolution. The centralised bodies and JSTs are likely to have a far better understanding overtime of the home and host positions that may have been camouflaged along national lines. However, in the cases of Bulgaria and Croatia, it would mean no national bank would be supervised by the ECB but only the subsidiaries of the EU banks as they make up the different ways of categorising significance.

On the macroprudential side, Bulgaria and Croatia have more discretion in close cooperation and have taken a more precautionary approach of designating a larger number of banks as O-SII, so domestically significant. In this case, all banks that are designated as O-SIIs in Bulgaria and all but three banks in Croatia. The case of Croatia suggests how important other aspects of determining significance such the relevance of the cross border activity are when deciding the categorisation of banks which are implicit in their business model.

A principal concern of entering close cooperation will always be the benefits of centralised decision making when it comes to burden sharing during times of crisis. The observation by Enria of a two-tier public interest test in resolution decisions is certainly a continuing concern. In view of the potential outcomes of banks in the two Member States classed as significant for the purposes of supervision yet not critical for the purposes of initiating resolution. Therefore, potentially earmarking them, by the SRB, for domestic bank insolvency-liquidation proceedings which may not have been the outcome anticipated ex ante under the domestic resolution regime for those ‘less significant’, but nonetheless, domestically important banks. Furthermore, the move towards EDIS is likely to improve funding for covered deposits. However, the dominant subsidiary based model of banking and their current target fund levels mean that both Bulgaria and Croatia are relatively well placed so not exposed to contentious burden sharing issues that could emerge if the branch based model was dominant and the exposure of the home authorities to host depositors would be larger.