

INCENTIVE COMPATIBLE RELATIONSHIP  
BETWEEN THE ERM II AND CLOSE  
COOPERATION IN THE BANKING UNION:  
THE CASES OF BULGARIA AND CROATIA

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## Abstract

The goal of expanding participation in the European Banking Union was to allow the “outs” to enter into close cooperation, but it did not include the simultaneous joining of the Exchange Rate Mechanism (ERM II). Focusing on the cases of Bulgaria and Croatia, this paper attempts to respond to various questions. What is the rationale behind the double requirement of having simultaneously to apply to become a member of the ERM II and to prepare to become a member of the Banking Union via the rule-based “close-cooperation” coordination mechanism between the EU non-euro-area national competent authorities (NCAs) and the European Central Bank (ECB)? Does the integration of close-cooperation countries’ banking systems with the euro-area banking systems support the decision to join the ERM II and “opting in” to the Single Supervisory Mechanism (SSM)? What are the advantages of preparing to become a full member of the euro area and the SSM? It is evident from the research undertaken in this paper that there are clear benefits of close cooperation for these 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. It is more difficult for a national central bank or NCA to exercise discretion in implementing ECB decisions once it is committed to the path leading to full European Monetary Union (EMU) membership. Hence the commitment to join the EMU minimises the authority risk for the ECB as well as for the Single Resolution Board, as safeguards become non-significant and termination is not an issue. The uncertainty about the functioning and durability of the close-cooperation arrangement is largely removed.

**Keywords:** banking union, close cooperation, ERM II.

**JEL classification:** E02, E44, F15, G15, G21, H12, K23.

## Resumen

El objetivo de ampliar la participación en la unión bancaria europea era permitir que los países *outs* entablaran una cooperación estrecha, pero no incluía la participación simultánea en el mecanismo de tipo de cambio (ERM II, por sus siglas en inglés). Centrándose en los casos de Bulgaria y Croacia, este documento intenta responder a varias preguntas. ¿Cuál es la justificación del doble requisito de tener que postularse simultáneamente para convertirse en miembro del ERM II y prepararse para convertirse en miembro de la unión bancaria a través del mecanismo de coordinación de «estrecha cooperación», basado en normas entre las autoridades nacionales competentes (ANC) de los países de la Unión Europea que no pertenecen al área del euro y el Banco Central Europeo (BCE)? ¿La integración de los sistemas bancarios de los países en estrecha cooperación con los sistemas bancarios de la zona del euro respalda la decisión de adherirse al ERM II y «optar» por el Mecanismo Único de Supervisión (MUS)? ¿Cuáles son las ventajas de prepararse para convertirse en miembro de pleno derecho de la zona del euro y del MUS? A partir de la investigación realizada en este documento, es evidente que existen claros beneficios de una estrecha cooperación para estos Estados miembros cuyas monedas nacionales ya están vinculadas al euro, en vista de la posición dominante que tienen los bancos de la eurozona en sus respectivos mercados nacionales. Es más difícil para un banco central nacional o una ANC ejercer su discreción en la implementación de las decisiones del BCE una vez que está comprometido con el camino que conduce a la plena adhesión a la Unión Económica y Monetaria (UEM). Por lo tanto, el compromiso de unirse a la UEM minimiza el riesgo de autoridad para el BCE y para la Junta Única de Resolución, ya que las salvaguardias dejan de ser significativas y la rescisión no es un problema. La incertidumbre sobre el funcionamiento y la durabilidad del acuerdo de cooperación estrecha se ha eliminado en gran medida.

**Palabras clave:** unión bancaria, estrecha colaboración, mecanismo de tipos de cambio II.

**Códigos JEL:** E02, E44, F15, G15, G21, H12, K23.

## **Index**

<b>Abstract</b>	5
<b>Resumen</b>	6
<b>1 Introduction</b>	8
<b>2 The duality of ERM II membership and entering close cooperation</b>	10
<b>3 The features of the banking systems as a rationale for entering 'close cooperation' under the SSM when applying to the EMU</b>	13
<b>4 The supervisory incentives to enter into close cooperation when applying for membership of the EMU</b>	17
4.1 The case of macroprudential supervision in close cooperation when applying for membership of the euro	19
<b>5 The crisis management incentives for entering into close cooperation when applying to EMU</b>	23
5.1 Deposit Guarantee Scheme	25
<b>6 Conclusion</b>	28
<b>References</b>	30

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 Juncker 2017

## 1 Introduction

Negative externalities can be associated with cross-border financial problems involving either instability across European markets, including sovereign debt, or systemically important European financial institutions with large cross-border operations and financial exposures. Against this backdrop, since the global financial crisis the euro area has 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 towards capturing potential efficiency gains through policy coordination (Nieto and Schinasi 2007; Emter, Schmitz, and Tirpak 2017; Claessens and Horen 2014; Milesi-Ferretti and Tille 2010; Brunnermeier 2009).

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

The global financial crisis 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 euro-area 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 – the European Central Bank (ECB) Governing Council, the SSM and the crisis management arrangements (the SRB), hereinafter referred to as Banking Union. Such separation raises a number of coordination problems, which have been partly dealt with by a rule-based “close-cooperation” mechanism for coordination between EU non-euro-area national competent authorities (NCAs) and the ECB. In this regard it is important to note the instruments of the Banking Union, as regulations confer centralised tasks and responsibilities on the ECB and the newly created SRB in euro-area and non-euro-area participating member states. The SRB mandate is limited by the Single Resolution Mechanism Regulation (SRMR) to those banks whose home supervisor is the ECB or an NCA in close cooperation. In view of this, member states entering into close cooperation need to introduce domestic law specifically to transfer decision-making from domestic administrative bodies to the designated centralised bodies (the ECB and SRB), and so participate in the SSM and Single Resolution Mechanism (SRM).



At present, the above-mentioned “close cooperation” has been exercised by two countries: Bulgaria and Croatia. Although the expectation of entry into the Exchange Rate Mechanism (ERM II) and later the adoption of the euro as a precursor to the Banking Union was not originally expressed in the Single Supervisory Mechanism (SSM) Regulation 2013, in the cases of both Bulgaria and Croatia the ECB Governing Council announced the inclusion of their respective currencies in the ERM II. In parallel, it also adopted a decision to establish “close cooperation” with their respective central banks following the fulfilment of the necessary supervisory and legislative prerequisites. Together, these two steps pave the way for Bulgaria’s and Croatia’s future participation in the euro area. The joint application to include their currencies in the ERM II in compliance with the convergence criteria to join the euro and the decision to establish “close cooperation” between the ECB and the central banks of Bulgaria and Croatia aims at solving the “financial trilemma” by moving powers for financial policies (regulation, supervision and stability) further to the European level.<sup>1</sup>

Focusing on the cases of Bulgaria and Croatia, this paper attempts to respond to several questions. What is the rationale behind the double requirement of having simultaneously to apply to become a member of the ERM II and to prepare to become a member of the Banking Union via the rule-based “close-cooperation” coordination mechanism 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 the ERM II and “opt in” to the SSM? What are the advantages of preparation to become a full member of the euro area and the SSM (e.g. coordination of macroprudential and microprudential regulation; coordination of microprudential supervision and bank resolution)?

This paper is divided in five sections in addition to this introduction. Section 2 analyses the rationale of the double requirement to apply to join 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 (Bulgaria and Croatia) that applied to join the ERM II, including the importance of the presence of euro-area banks. Section 4 analyses cooperation in normal times during the “close-cooperation” period: cooperation in microprudential and macroprudential supervision while fulfilling the nominal convergence criteria to join the European Monetary Union (EMU). Section 5 analyses cooperation in times of crisis when there is a need to resolve or liquidate a bank. In particular, it examines the incentives to cooperate under those circumstances in the context of becoming a member of the EMU. The final section offers some conclusions.

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<sup>1</sup> The financial trilemma states that financial stability, financial integration and national financial policies are incompatible. Any two of the three objectives can be combined, but not all three; one has to give. The concept was developed by Schoenmaker 2011, 57-59.

## 2 The duality of ERM II membership and entering close cooperation

In the cases of Bulgaria and Croatia, the ECB Governing Council adopted a decision to establish close cooperation with the other relevant central banks following the fulfilment of the necessary supervisory and legislative prerequisites. In parallel, the inclusion of their respective currencies in the ERM II was announced.<sup>2</sup> Together, these two steps pave the way for Bulgaria's and Croatia's future participation in the euro area. (European Central Bank 2020c, 2020b).<sup>3</sup>

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's] 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.<sup>4</sup>

We should bear in mind that the requirement to join the ERM II was envisaged by the Maastricht Treaty and policymakers as a transition stage aimed at ensuring that member states seeking to adopt the euro can meet the principles of the ERM II, which are as follows:<sup>5</sup>

- 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;
- [to] provide a reference for their conduct of sound economic policies in general and monetary policy in particular; and
- [to] protect non euro area Member States from unwarranted pressures in the foreign-exchange markets.

<sup>2</sup> The central parities and the standard fluctuation bands of plus or minus 15 per cent for both the Bulgarian lev and the Croatian kuna were agreed on 10 July 2020. See European Central Bank 2020d, 2020a. Following a careful assessment of the appropriateness and sustainability of Bulgaria's currency board, it was accepted that Bulgaria is joining the ERM with its existing currency board arrangement in place as a unilateral commitment, thus putting no additional obligations on the ECB.

<sup>3</sup> Starting from 1 October 2020, the ECB will be in charge of direct supervision of the significant institutions in Croatia and Bulgaria and the common procedures for all supervised entities, as well as 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.

<sup>4</sup> The letter of the Euro Group president explicitly states: "In the future, we expect to follow a similar approach for Member States wishing to join ERM II, in line with the principle of equal treatment." This was the case when Croatia applied in July 2019. See European Central Bank 2017; Annex 2 of ERM II Mechanism 2018.

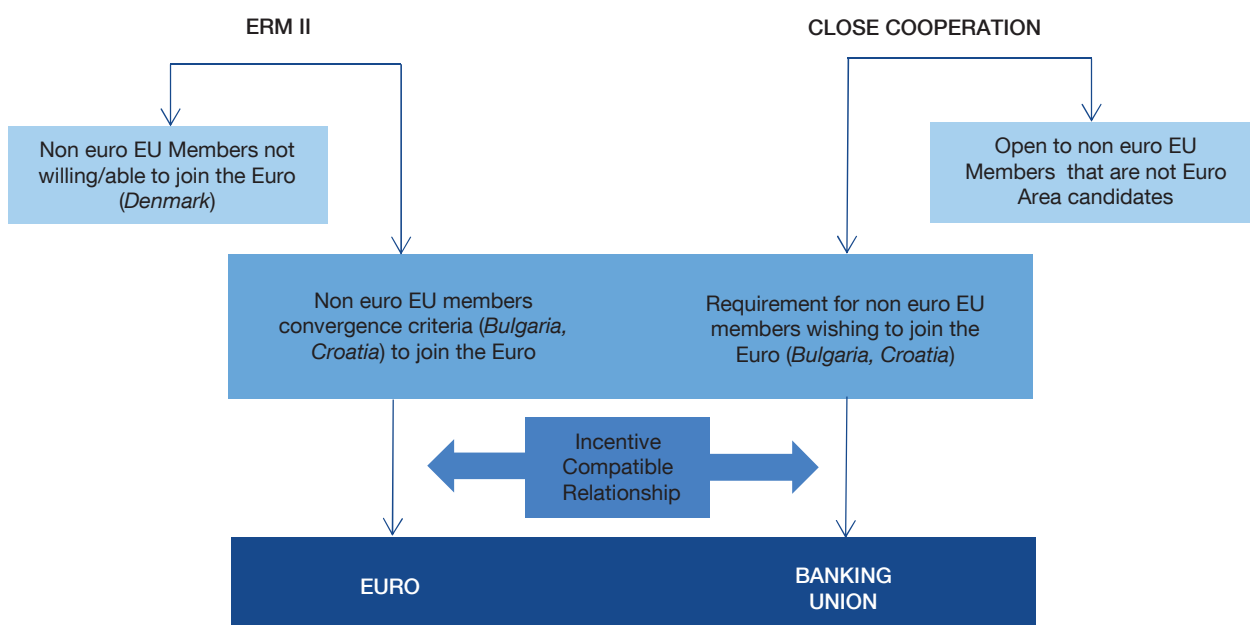
<sup>5</sup> Articles 140–142 of the Treaty on the Functioning of the European Union (TFEU); Consolidated Version of the TFEU Protocol (No. 13) on the Convergence Criteria [2016]; Point 1.3 of Resolution on the European Council on the Establishment of an Exchange-rate Mechanism in the Third Stage of Economic and Monetary Union [1997]. Inter institutional 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]. See also Smits 1997, 465-466, and Zilioli and Selmayr 2004, 133-137. For a discussion about other member states possibly entering close cooperation see Jensen and Schoenmaker 2020, 317-326.

Hence participation in the ERM II is a precondition for as well as fulfilment of the nominal convergence criteria to join the euro, and as such it is binding and of a temporary nature (ERM II Central Bank Agreement 2006). 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 deutschmark, and subsequently with the euro after 1999) after a devastating debt and banking crisis in 1997. Croatia had a peg first with the deutschmark, and from 1999 to the euro, with a narrow band. All the countries that joined the ERM have become members of the EMU<sup>6</sup> with the sole exception of Denmark, which opted out of the obligation to become a member by virtue of Protocols Nos 15 and 16 (Council of the EU 2019).

After the launch of the SSM, as an integral part of the institutional architecture of the euro, it was rational that EU policymakers would expect EU Member States when joining the ERM II would require simultaneous close cooperation with ECB, following fulfilment of the necessary supervisory and legislative prerequisites. The first step was in preparation to become a member of the euro, and the second step to become a member of the Banking

Figure 1

**WHAT INCENTIVE COMPATIBLE MEANS**



SOURCE: Author's analysis.

6 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) and Slovakia (25 November 2005). See ERM II Central Bank Agreement 2006.

Union. In turn, 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 NCAs and the SSM.

The requirement for close cooperation when applying to the ERM II deals with the “efficiency” gaps in the pre-existing arrangements that neglect the possibility of negative bank sovereign “loops” (Podstawski and Velinov 2018, 63, Dumitrescu-Pasecinic 2019, 320, 357 - 358). Against this background, as is the case for the ERM II, the “participation” mechanism should be understood as a binding requirement of a 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 general governance arrangements of Art. 7 of the SSM Regulation, in which the possibility of “opting out” fades with the incentives for joining the euro. Art. 7 of the SSM Regulation and its modalities (set out primarily in the SSM Framework Regulation 2014 and the 2014 ECB Close Cooperation Decision) permit non-euro-area member states to participate in the SSM through a close-cooperation arrangement. Figure 1 presents the options open to non-euro EU countries in terms of participation in the ERM II and/or the close-cooperation arrangement. Only simultaneous participation with a view to joining the euro is incentive compatible, as explained in this paper.

### 3 The features of the banking systems as a rationale for entering “close-cooperation” under the SSM when applying to the EMU

The interconnection of the banking systems of Bulgaria and Croatia with those of the other EU member states (mainly euro area) creates incentives for applying to the ERM II to join the euro and for “close-cooperation” with the Banking Union following its accessions to EU in 2007 and 2013 respectively. 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.<sup>7</sup>

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 a banking crisis, as was the case in Bulgaria, and, finally, the opportunity for foreign banks to play a dominant role in view of the limited size of domestic banks – as was the case in both Bulgaria and Croatia (Fontán et al. 2019). Table 1 shows the important presence of EU banks, mostly in the form of subsidiaries, in Bulgaria and Croatia.

The banking systems in Bulgaria and Croatia 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 per cent of total market share by assets, and of this share 76.43 per cent is owned by euro-area banks and 100 per cent is foreign owned (euro area and non-euro EU). The Bulgarian banking system is less concentrated than the Croatian system, a likely result of the devastating banking crisis in Bulgaria in 1997. In Croatia, Table 2a, the ECB-designated significant banks are all foreign subsidiaries of euro-area banks. The total market share of the significant banks is 72.91 per cent, and of that 100 per cent is owned by euro-area banks. The proportion of total assets of the top three significant banks in Bulgaria and Croatia is 42.76 per cent and 53.61 per cent respectively, indicating their economic importance in these member states. Considering the countries’ consolidated banking assets, the banking sector is relatively small in comparison to GDP, at 11 per cent in Bulgaria and close to 13 per cent in Croatia, which suggests that the systemic risk exposure of the banking sector to the real economy is comparatively limited – although a disorderly bank crisis could well morph into a systemic crisis.

The criteria to assess if a credit institution will fall under the supervision of the ECB are set out in Art. 6 (4)(i)–(iii) of the SSM Regulation, and specifically refer to its size, importance for the EU or any participating member state, and finally the significance of its cross-border activities. While there is further elaboration of the criteria in the SSM Regulation, it is not entirely complete, with the ECB utilising its discretion to determine the significance of banks by considering other factors as well, as follows:

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<sup>7</sup> 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.’ See European Central Bank 2019a.

Table 1

**TOTAL NUMBER OF BANKS, BRANCHES AND SUBSIDIARIES: BULGARIA AND CROATIA (2018)**

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:** European Central Bank 2020d.

- whether the total value of its assets exceeds €30 billion (neither Bulgaria nor Croatia has a bank of this size);
- whether the ratio of a banks total assets to GDP in the participating member state exceeds 20 per cent, (unless the total value of its assets is below €5 billion). No bank meets this criterion in Bulgaria or in Croatia;
- for cross-border exposures in terms of assets and liabilities, in view of the ECB anticipating directly supervising significant banking groups, whether it has identified banks in both Bulgaria and Croatia that fall within this category;
- whether the bank is among the three most significant credit institutions in the participating member state (see Table 2 and Table 2a– the ECB has designated three banks in both Bulgaria and Croatia that fall into this category, which is in line with similar euro-area member states), unless justified by circumstances.

In the case of Croatia and Bulgaria, the third and fourth criteria seem to be those used by the ECB to assess whether a bank will fall under its supervision (ECB Press Release 2020e). In line with other relatively small member states, the use of the last criterion is not unusual. Although the ECB does not have directly applicable powers over supervised entities in Bulgaria and Croatia, it is empowered to address specific and general “instructions” regarding approximately 58 per cent of the banking market in Bulgaria and 73 per cent of the market in Croatia (significant institutions) in terms of total assets as of December 2018 (Art. 7(1) of the SSM Regulation and Art. 107(3) of the SSM Framework Regulation).

The ECB, however, exercised its discretion in accordance with Art. 6(5)(b) of the SSM Regulation and Art. 67 of the SSM Framework Regulation, to bring into direct supervision a number of less significant banks that operate in Bulgaria and Croatia. In this category, the size of the bank in comparison to total assets is not the material factor in assessing 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 (Karagianni and Scholten 2018, 185-194, Annunziata 2020, 545 - 570, Tröger 2015, 167 - 192). However, the number of banks

Table 2

**BANKS INCLUDED IN THE ECB LIST OF BANKS DIRECTLY SUPERVISED IN BULGARIA AND CROATIA**

EU Non-euro area country		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 Banking Assets / GDP (2018)
Bulgaria	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%	
Total			61,317,144	58.09%	10,555,661,901	99,000,000,000	6.19%	11%	
Croatia	Zagrebacka Banka DD	Y (Unicredit SPA Italy)	1	113,243,331	23.66%			3.04%	
	Privredna Banka Zagreb D.D	Y (Intesa Sanpaolo Italy)	2	83,023,299	17.27%			2.23%	
	Erste & Steiermarkische Bank DD	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%	
Total			321,517,987	72.91%	48,070,732,880	372,300,000,000	8.64%	12.91%	

SOURCE: Bulgarian National Bank 2018, Croatia Central Bank 2019.

being classified as significant in accordance with Art. 6(5)(b) has been limited. According to the ECB list of significant banks by July 2020, the decision has been exercised only six times, and in most of those instances the banks are US institutions with multiple entities in the euro area. The ECB decision to exercise its discretion to classify banks as significant means Bulgaria and Croatia will have more significant banks (five and eight respectively) than some

of the larger member states of the euro area.<sup>8</sup> Moreover, they both have more significant banks than other similar-size euro-area member states, where only the top three are listed as significant. It is important to explore why some banks with very small levels of total assets are now classified as significant, which is not really clarified by the ECB on a case-by-case basis other than the note that they all are part of cross-border banks. In Bulgaria, Eurobank, ranked fourth in terms of total assets, is wholly owned by Eurobank Ergasias Services and Holdings SA, which has assistance from the Hellenic Financial Stability Facility to support its restructuring and remains partially owned by the facility (European Commission Decision 2014). In view of this assistance, the ECB has the discretion to supervise Eurobank directly in Bulgaria given its significant business operations in the member state. Adikko, originally a less significant bank in Austria, is now reclassified as a significant bank; as a result, its subsidiaries in Slovenia and Croatia, in view of their significance to the parent, are also classed in those member states as significant banks. Adikko was listed as an “other cross border group” by the SRB, so for the purposes of resolution fell within the remit of the SRB, albeit being a less significant bank for the purposes of the SSM (Single Resolution Board 2020, Annex I). In our view, the move to supervise Addiko AG group directly 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.

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<sup>8</sup> Whether this is a new policy direction whereby the number of significant banks will increase in accordance with Article 6(5)(b) is beyond the scope of this paper.



#### 4 The supervisory incentives to enter into close cooperation when applying for membership of the EMU

The two countries entering close cooperation depict a relationship common among relatively small member states that see their banking systems dominated by foreign banks from the larger member states in the euro area, where the largest parent cross-border banks are domiciled. This top-down relationship between large banks in the euro area and small banks outside the euro area gives rise to information asymmetry challenges that are common between home and host authorities of different parts of a banking group. In the euro area, those challenges have particular consequences (Herring 2007). This is especially important where entities residing in the host country are critical to the host market but not necessarily critical to the parent group in the home market – an important area of research highlighted by Herring 2007 and more recently by Pistor 2010.<sup>9</sup> In this relationship either the home or the host can forbear timely sharing of information and, critically, decide whether to share the burden of financial support for distressed parts of the group with their foreign counterpart, only when it serves their self-interest. Thus an acute challenge for small hosts is 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 information asymmetries and the lack of incentive to cooperate among host and home authorities, taking the financial trilemma to its logical conclusion by moving powers for financial policies (regulation, supervision and stability) further to the European level. It is now evident that the relationship between the ECB and those EU member states in “close cooperation” in the Banking Union is one that is “comparable” with rather than “equivalent” to its eurozone counterparts (Art. 107(2) of the SSM Framework Regulation, Singh 2020, 33).

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 (European Central Bank 2017). In this relationship, Art. 18(1) of the SRMR specifies the close-cooperation countries enact legislation to share the responsibility of supervision and resolution with the ECB and SRB. The decisions made by the ECB and SRB are executed by the domestic competent authorities and resolution authorities. In this respect, the ECB does not have direct supervision of significant banks in Bulgaria and Croatia as it does with significant banks in eurozone member states.

The ECB will instruct the Bulgarian and Croatian central banks as prudential supervisors in terms of microprudential supervision and, in part, macroprudential supervision (Art. 108 (1-5) of the SSM Framework Regulation, European Central Bank 2018, 2019d, 2020a, 2019c, 2020b). The latter is primarily within the discretion of the Bulgarian and Croatian national banks but will now be open to scrutiny by the ECB, which may request adopting or increasing levels of capital and liquidity to manage macroprudential risks (Art. 5 of the SSM Regulation). Art. 7 gives the ECB the authority to change macroprudential

<sup>9</sup> For a historical perspective see Mayes and Vesala 1998, Pistor 2010, D’Hulster 2011, Ferrarini and Chiarella 2013, 6-10, Avgouleas 2012, 422-423.

capital buffers, but the NDA retains the power to decide which banks are designated other systemically important institutions (O-SIIs). 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. Table 3 shows the complexity of macroprudential regulation that impacts banks' capital as well as the need for coordination between the home (ECB) and host (Central Banks of Croatia and Bulgaria) NDAs, particularly when reciprocity is required to limit sectoral sources of systemic risk (European Central Bank 2020b, 2020c).

The SSM Regulation, particularly Art. 4(1)–(2) on supervision, Art. 5 concerning macroprudential action and Art. 6 detailing the allocation of tasks between the ECB and NCAs and NDAs and 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 “indirect” authority of the ECB over the supervised entities, while it exercises a direct authority over the NCAs and NDAs according to Art. 107(2) of the SSM Framework Regulation; the buttressing techniques of the ECB's operating effectiveness; the deterrence mechanisms of the ECB to back its authority; the safeguards of the non-euro-area member states which lack 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.<sup>10</sup>

When a close-cooperation arrangement is in place, the ECB decisions addressed to supervised entities (both significant and less significant) are replaced by instructions to NCAs and NDAs (Art. 108 of the SSM Framework Regulation). NCAs then adopt national administrative measures or otherwise execute the ECB's instructions. As Moloney 2019 describes it, the ECB decision-making is therefore intermediated. As the cooperation arrangement is a precondition to joining the euro in the case of Bulgaria and Croatia, 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. The commitment to join the EMU minimises the risks of exiting the cooperation in the absence of arrangements for orderly withdrawal in the SSM Framework.<sup>11</sup>

The applicant member state benefits from access to the supervisory expertise of joint supervisory teams (JSTs), thus essentially hiring the credibility of the SSM (Lastra 2019). The credibility of the NCAs will be boosted, as will the reputation of their banking systems (Ernia 2019). JSTs are the vehicle for the exchange of information and coordination among NCAs and the ECB in the realms of prudential regulation and supervision. This is particularly relevant in the case of banking systems dominated by subsidiaries of euro-area banks. Moreover, the JSTs, which are always headed by SSM staff, contribute to

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<sup>10</sup> Article 7(5)–(8) of SSM Regulation; Article 6 of Decision ECB/2014/5; Articles 118–119 of SSM Framework Regulation.

<sup>11</sup> The termination of the close cooperation takes place 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. Thus there is a minimum arrangement aimed at ensuring an orderly withdrawal. The authors thank Adrian Dumitrescu for bringing this point to their attention.

buttressing the ECB's authority. Finally, the SSM is broad in scope and very large in size, allowing it to exploit economies of scale with regard to expert knowledge (Ernia 2019).

The issues related to the lack of representation of the central banks as prudential supervisory authorities entering into close cooperation with the ECB in its decision-making structures (Supervisory Board and 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 (ECB Decision 2020e, 2020f) namely, a representative of each of the central banks as the prudential supervisory authority participates and exercises voting rights in the Supervisory Board; and the central bank representative to the Supervisory Board participates and exercises voting rights in deliberations on the adoption by the ECB of instructions with regard to the identification of significant supervised entities established in their countries pursuant to Art. 110 of the SSM Framework Regulation.

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 (including the convergence criteria related to the ERM II). The benefits of the close-cooperation arrangement and participation in the SSM are several and constitute an important incentive for these countries to align their supervisory practices with the ECB and develop a good working relationship between the ECB and their NCAs. Both countries are aligning their supervisory practices to the highest standards – indeed, the ECB can be considered de facto a standard setter (Darvas and Wolf 2013, Belke et al. 2016, 119, Kudrna 2016, 119, MÉRÖ and Piroška 2016, 215, Mitreġa-Niestrój and Puszer 2015, 400-407, Vollmer 2016, 7). Moreover, the commitment to join the Monetary Union minimises the authority risk for the ECB, as safeguards become insignificant and termination is a non-issue. Hence, the incentive for simultaneous application to join the ERM II and to enter close cooperation is apparent, as incentives for joining the Monetary Union and being part of the Banking Union converge.

#### **4.1 The case of macroprudential supervision in close cooperation when applying for membership of the euro**

The complementarity of monetary and macroprudential policies yields superior outcomes to a world where monetary policy – or macroprudential policy – is pursued on its own and in the absence of the other policy (Nier and Kang 2016, 27 - 38). One argument is that macroprudential policy can build buffers that can be eased in periods of financial stress. Such a policy can help keep open the transmission of monetary policy, preserving its effectiveness in the event of such stress. This is the rationale for preparing to join both the EMU and the Banking Union.

Table 3 shows that both Bulgaria and Croatia generally classify banks included in the ECB list of significant banks as O-SIIs, and illustrates the capital buffer rate they are expected to build up according to the existing macroprudential rules in the EU. The exceptions are in Croatia, where Raiffeisen Stambena Stedionica DD-Croatia and PBZ Stambena Stedinoca DD are not designated as O-SIIs despite the fact that their parents,

Table 3

**MACROPRUDENTIAL MEASURES: BANKS IN THE ECB LIST OF BANKS DIRECTLY SUPERVISED IN BULGARIA AND CROATIA**

EU Non-euro area country	Largest Commercial Banks including subsidiaries	Affiliate of euro-area bank	GSIB/O-SIB (applicable home country, announcement dates)	O-SIB (applicable host country, announcement 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 (M) or Voluntary (V) reciprocity
			O-SII not subject to reciprocity		Affected by the rate where exposures are located	Subject to Reciprocity CRD Art 133	Macroprudential Measure
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)	Italy (None)
	DSK Bank Plc	N (OTP Bank Plc Hungary)	OTP Bank: 2% (01/2020)	DSK Bank: 1% (01/2020) (11/2019)		Hungary (None)	Hungary (None)
	United Bulgarian Bank - UBB	Y (KBC Belgium)	KBC: 1.5% (12/2019)	United Bulgarian: 1% (01/2020) (11/2019)		Belgium (None)	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
	Raiffeisen Bulgaria	Y (Raiffeisen Bank Austria)	Raiffeisenbank Bank Int1: 2% (01/2020)	Raiffeisenbank Bulgaria: 0.75% (01/2020) (11/2019)		Austria (2% All Exposures)	Austria (None)
	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)	Greece (None)
Comments						Bulgaria applies to all banks based only to their domestic exposures a SRB of 3% over total risk exposure since 2014 and subsequently reaffirmed. Reciprocation is not required.	

**SOURCES:** European Systemic Risk Board web page and authors' analysis.

Raiffesen Bank International and Intesa Sanpaolo respectively, are O-SIIs in their home countries. Also, Adiko Bank DD is designated as an O-SII by the Croatian authorities although it is not by its home NDA (Luxembourg). As mentioned, both member states have identified a large proportion of their banks as systemically important from a domestic perspective. This shows that the O-SII criteria utilise an approach that focuses on the domestic systemic

Table 3

**MACROPRUDENTIAL MEASURES: BANKS IN THE ECB LIST OF BANKS DIRECTLY SUPERVISED IN BULGARIA AND CROATIA (cont'd)**

EU Non-euro area country	Largest Commercial Banks including subsidiaries	Affiliate of euro-area bank	GSIB/O-SIB (applicable home country, announcement dates)	O-SIB (applicable host country, announcement 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 Reciprocity CRD Art 133	Macroprudential Measure	
Croatia	Zagrebacka Banka DD	Y(Unicredit SPA Italy)	G-SIB Unicredit: 1% (12/2019)	Unicredit: 2% (12/2019)	Croatia: None	Italy (None)	Italy (None)
	Privredna Banka Zagreb DD	Y(Intesa Sanpaolo Italy)	Intesa Sanpaolo: 0.56% (1/20), 0.75%(1/21) (11/2019)	Privredna Banka: 2% (12/2019)		Italy (None)	Italy (None)
	Erste & Steiermarkische Bank DD	Y(Erste Group Bank Austria)	Erste Group Bank: 2% (01/2020)	Erste & S Bank: 2% (01/2020)		Austria (2% All Exposures)	Austria (None)
	Raiffeisen Bank Austria DD	Y (Raiffeisen Bank Austria)	Raiffeisen Bank Int'l: 2% (01/2020)	Raiffeisen Bank Zagreb: 2% (01/2020)		Austria (2% All Exposures)	Austria (None)
	Raiffeisen stambena štedionica d.d.	Y (Raiffeisen Bank Austria)	Raiffeisen Bank Int'l: 2% (01/2020)	NA		Austria (2% All Exposures)	Austria (None)
	Adiko Bank DD	Y(AI LAKE S.a.r.l.,Luxemburg)	NA	Adiko Bank d.d. 1% (01/2020)		Luxemburg NA	Luxemburg (None)
	Sberbank DD	Y (Sberbank Europe AG Austria)	NA	NA		Austria (1% All Exposures)	Austria (None)
	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)	Italy (None)

**SOURCES:** European Systemic Risk Board web page and authors' analysis.

implications by assessing the extent to which a bank's business activities are substitutable and the level of interconnectedness within the market.

The banks designated by Bulgaria as O-SIIs are also classified as such in the ultimate parent member states. For example, in Bulgaria Unicredit Bulbank AD, United Bulgarian Bank and Raiffeisenbank Austria DD are designated as O-SIIs and so are the parents, Unicredit SPA (G-SIB), KBC (O-SII) and Raiffeisenbank (O-SII) in Italy, Belgium and Austria respectively. In the case of Croatia, Zagrebacka Banka DD, Privredna Banka Zagreb DD and Erste & Steiermarkische Bank DD are designated as O-SII and so are the parents, Unicredit SPA (G-SIB), Intesa Sanpaolo and Erste Group Bank (O-SIIs) in Italy and Austria respectively.

The Article 135 of the Capital Requirement Directive 2013/36/EU 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.<sup>12</sup> Currently, only Austria – where the ultimate parent resides – has taken reciprocal measures either to increase or to reduce the capital buffer rates. Under close cooperation, the ECB may request countries to adopt or increase levels of capital and liquidity for the purposes of managing counter-cyclical and systemic macro-prudential risks.

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**12** For the powers of the European Systemic Risk Board to recommend reciprocity, see European Systemic Risk Board 2018, 48. The reported rate in Table 3 is the rate applied to domestic exposures, and 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 Article 133(5) of the Capital Requirement Directive.

## 5 The crisis management incentives for entering into close cooperation when applying to EMU

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 (NRA) to the SRB, with the practical execution of the resolution scheme residing with the NRA (European Central Bank 2019b). The operation of close cooperation within the SRM will not differ much from the operation of the SRM within the euro area. Furthermore, as it is the case for euro-area countries, member states in close cooperation retain critical responsibilities for emergency liquidity assistance and precautionary recapitalisation of solvent banks that have short-term liquidity and capital assistance needs (Art. 32(4) and 31 of the BRRD). These responsibilities reside at the national level regardless of whether a member state is in close cooperation or a full-fledged member of the eurozone.

A critical feature has been the move towards mutualisation of financial support through the Single Resolution Fund (SRF) (ECB 2019b). In this respect, those entering close cooperation are required to introduce legislation to mutualise their national fund formally with the other participating member states that are already members of the EMU. The reduction of autonomy is offset by access to a larger pool of funds for bank crisis resolution, including the possibility of a backstop credit line from the European Stability Mechanism (ESM) (Agreement amending the Treaty Establishing the European Stability Mechanism 2021, Agreement amending Intergovernmental Agreement 2021). The common backstop will help to ensure that a bank failure does not harm the broader economy or cause financial instability.

The most debatable aspect of close cooperation, as in the Banking Union, is likely to be in the field of resolution decision-making (Binder 2019, 314 - 330). The ECB decides for significant banks whether a bank is failing or likely to fail, and the SRB decides how the bank will be resolved in either resolution or insolvency liquidation (Art. 18(1) SRMR). For the significant banks of Bulgaria and Croatia it will be the SRB's responsibility to decide which resolution options to use – resolution or insolvency proceedings, according to national law. This relocates decision-making away from the NCA of the relevant member state, so the question that arises is how is this administered? Is participation in close cooperation equivalent or comparable to euro-area member states' participation?

Member states entering close cooperation must introduce legislation to ensure the NRA has the legal administrative authority to adhere to SRB decisions within the SRM. In the cases of Bulgaria<sup>13</sup> and Croatia<sup>14</sup> domestic legislation was amended to this effect. The

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13 Law amending and supplementing the Law on Rehabilitation and Restructuring of Credit Institutions and Investment Intermediaries, Decree No. 103, 2 May 2019.

14 The Act on the amendments to the Credit Institutions Act (Official Gazette No 47/20).

reforms ensure the tasks and decisions of the NRA comply with the SRMR. The domestic legislative reforms extends to SRB decisions, guidelines and general instructions. In this respect, Ivana Parać Vukomanović 2020, director of the Croatia National Bank Financial and Supervisory Law Department, highlights the important distinction between close cooperation in the SSM and SRM: the SRB has “direct authority” in Croatia, in contrast to the ECB within the SSM (“indirect authority” via the NCA) (Vukomanović 2020, 73). It is argued the SRB’s relationship with member states in close cooperation within the SRM is therefore “equivalent” to rather than “comparable” with the ECB in the SSM, as shown above.

According to Art. 7(1), 8 and 10 of the SRMR, the SRB in the SRM is reliant on the NRA to execute its resolution strategy. The SRB exercises a range of responsibilities on behalf of member states in close cooperation, such as assessing resolvability and resolution planning to decide on the ultimate resolution strategy (Art. 7(2) of the SRMR). Disputes relating to these matters between the SRB and NRAs are open to appeal to the SRB Appeal Panel as specified under Art. 85 of the SRMR). The decision of the Appeal Panel is binding, and the decision in question will need to be amended accordingly (Art. 85(7) of the SRMR).

These responsibilities are specifically exercised over designated significant banks or those the ECB decides to supervise directly, and other SRB designated cross-border groups according to Art. 7(2)(a)(b) of SRMR. The compliance of member states in close cooperation emanates from the fact that they are participants in the SRMR, similar to euro-area member states, and thus fall within each part of the SRMR requirements as if they were euro-area member states. The exception is the possibility of the member state terminating close cooperation in the SSM and so also the SRM as a participating member state (Art. 7 of SSM Regulation, Art. 4(2)(3) of SRMR).

Bulgaria and Croatia introduced domestic legislation to transfer and mutualise their resolution funds with the SRF.<sup>15</sup> Ratification of the Intergovernmental Agreement on the Single Resolution Fund (IGA) 2014 opens the door for Bulgaria and Croatia entering into close cooperation. Art. 12 and 13 of the IGA give contracting parties the possibility of future ratification of the agreement. This enables member states committed to entering close cooperation to make the requisite transfers from a domestic resolution fund in compliance with the target level for its resolution financing arrangements of 1 per cent of the covered deposits of all credit institutions (Art. 8 of the IGA, Art. 67 (4) of the SRMR). The IGA ceases to apply, in line with Art. 7(2) of the SSM, once a member state terminates close cooperation in the SSM (Art. 12 of the IGA). Art. 15 of the IGA provides reimbursement once a member state no longer participates in the SSM, that also in line with Art. 4(3)(a)-(c) of the SRMR. However, as explained above, the possibility of termination fades with the commitment to join the euro once Bulgaria and Croatia fulfil the convergence criteria.

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<sup>15</sup> Bulgaria: Act ratifying the Agreement on the transfer and mutual use of contributions to the Single Restructuring Fund, Decree No. 264; Croatia: Official Gazette, International Part No 1/2020.



The recent reforms to the Treaty Establishing the ESM 2011 provide a separate backstop to the SRF if its resources are depleted by its use in a bank resolution. The Amended ESM Treaty 2021 enables member states entering close cooperation to contribute as participants. The Amended ESM Treaty 2021 formalises the initiative of the Euro Summit of 29 June 2018 to provide a backstop to the SRF. Member states in close cooperation are not contracting parties to the amending treaty, which remains exclusively for euro-area member states, but the backstop provides additional support to the SRF function of providing financial assistance during a crisis in a fiscally neutral manner. The reforms to the ESM to introduce the backstop provide incentives to enter close cooperation by guaranteeing the benefits of this backstop to the SRF. In many respects this is appropriate given that those entering into close cooperation are required to mutualise their national funds, so they should also benefit from the backstop and indeed contribute to that effort. The new Recital 9a of the Amended ESM Treaty 2021 enables those in close cooperation “to provide parallel credit lines for the SRF alongside the ESM”. According to Art. 6 of the Amended ESM Treaty 2021, participating member states will also be able to attend backstop-related meetings of the Board of Governors and Board of Directors of the ESM as observers.

## 5.1 Deposit Guarantee Scheme

In Bulgaria the Bulgarian National Bank is the resolution authority and the Deposit Guarantee Scheme (DGS) has responsibilities akin to those of a “paybox plus”, with resolution functions including managing the deposit guarantee fund and bank resolution fund, as well as appointing trustees in bank bankruptcy (IADI 2020). 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. Table 4 gives a comparison of the euro-area safety net and the safety nets of Bulgaria and Croatia. Croatia has two designated resolution authorities: the central bank and the DGS. In view of this, Croatian law had to be amended to give only the central bank the right to vote at the SRB plenary and executive sessions (Vukomanović 2020, 74). The Croatian DGS submits an opinion if it needs to be involved in a resolution strategy (Vukomanović 2020,74). In Bulgaria, the central bank is the resolution and it has the voting rights on the SRB plenary and executive sessions.

The SRMR extends to the potential use of the national DGS in resolution for participating member states according to the Art. 79 of the SRMR. The DGS remains a national competency in accordance with the DGS Directive in view of the lack of a European Deposit Insurance System. Art. 79(4) of the SRMR specifies the SRB could mandate national DGS funds in resolution to compensate covered depositors, and could use the DGS if the eligible deposits transferred via the sale of a business or bridge institution are below the aggregated covered level. In this respect, the Bulgarian BDIF, can provide financial assistance in the resolution of a bank by absorbing losses for the insured depositors in the resolution process. However, the powers it had to establish bridge institution and an asset management vehicle were transferred to the Bulgarian central bank. In a package of reforms while entering in to close cooperation which also saw its responsibility for managing

Table 4

**COMPARISON OF SAFETY NETS**

Safety-net characteristics	Euro-area significant banks	Croatia	Bulgaria
Resolution	SRB/SRF (responsibility for insolvency-liquidation proceeding delegated to national designated authorities)	NCB is the resolution authority (Central Bank of Croatia 2020)	NCB is the resolution authority. (Art. 16.16 of Law on Bulgarian National Bank 2020b, 2020a)
DGS	Decentralised (some with resolution powers) and harmonisation by Directive Recast 2014 planned European Deposit Insurance System	DGS has some resolution powers as well as responsibility for compensation payouts	DGS is only responsible for compensation payouts
Emergency Lending Facility	NCBs (ECB, Agreement on ELA, 17 May 2017)	Central Bank of Croatia	Central Bank of Bulgaria (within limits of its FX holdings)

**SOURCE:** Authors' analysis.

the resolution fund with it ultimately being mutualised with the SRF.<sup>16</sup> This emphasises the importance of the funding levels of the national DGSs.

The level of confidence in the DGS of any banking system relies on a variety of factors, with the level of pre-existing funds for covering depositor reimbursements being the principal element (European Banking Authority 2020). The DGS Directive expects member states to have in place a target-level fund of 0.8 per cent of covered deposits, although in exceptional cases it can be as low as 0.5 per cent.<sup>17</sup> Bulgaria and Croatia have both opted for much higher target levels, with 1.0 per cent (Bulgaria) and 2.5 per cent (Croatia) of covered deposits; more importantly, Croatia has achieved the funding level and Bulgaria is only just below the target. In these cases it must be a precautionary sign of the likely use of the DGS fund, yet it also indicates prudence exercised by both countries.

The proportion of EU bank subsidiaries in comparison to the number of EU branches is significantly higher in both Bulgaria and Croatia in comparison to other EU member states where a branch-based model is prevalent (with Luxembourg as the exception – see Appendix 6, Table 6.1, Singh 2020). 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 of the European Parliament and of the Council Directive 2014/49/EU on Deposit Guarantee Schemes 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 to branch depositors according to the home-country DGS's instructions. The home DGS can also request financial assistance from the host

<sup>16</sup> § 56, para 1 of the Transitional and Final Provisions of the Law on Amendment of the LRRCIIF (State Gazette, issue 37 of 7 May 2019).

<sup>17</sup> The International Association of Deposit Insurers (IADI) highlights that a target level of 1.15 per cent was proposed, but this met opposition based on the view that resolution techniques and the resolution fund would reduce the burden on the DGS.

DGS to orchestrate a pay-out. The cooperation arrangement between the hosts' supervisors and the ECB would support the cooperation agreement between home and host DGSs, to the extent that potential losses and liquidity needs of the DGSs in Croatia and Bulgaria will be minimised by the limitation of information asymmetries and prudential supervisory practices at the highest standards.

## 6 Conclusion

This paper seeks to assess the incentives for entering close cooperation for two countries that are also applying to become members of the EMU (Bulgaria and Croatia) by looking at three key areas: the duality of ERM II membership and entering close cooperation, the supervisory incentives, and the crisis management incentives for entering into close cooperation when joining the EMU is the ultimate objective.

The expectation of entry into the ERM and later the adoption of the euro as a precursor to the Banking Union was not originally expressed in the SSM and SRM Regulations. The linkage of close cooperation to ERM II participation has the crucial effect of binding EMU-applying countries more closely to the Banking Union. It is more difficult for a national central bank or NCA to exercise discretion in implementing ECB decisions once it is committed to the path leading to full EMU membership. Hence the commitment to join the EMU minimises the authority risk for the ECB as well as the SRB, as safeguards become insignificant and termination is not an issue. Uncertainty about the functioning and durability of the close-cooperation arrangement is largely removed. The incentive for simultaneous application to join the ERM II and enter close cooperation is apparent, as the incentives for joining the EMU and being part of the Banking Union converge.

It is evident from the research undertaken in this paper that there are clear benefits of close cooperation for these member states whose domestic currencies are already linked to the euro, in view of the dominant position euro-area 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 the ECB's remit, in view of the ECB list of Bulgarian and Croatian banks that it supervises as of October 2020. The ECB's 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 the total assets of the banking systems in Bulgaria and Croatia (58.09 per cent and 73 per cent respectively) is brought under centralised supervision and resolution. In the cases of Bulgaria and Croatia, this means no national bank would be supervised by the ECB but only the subsidiaries of the foreign EU banks. Since foreign EU banks in Bulgaria and Croatia make up the different ways of categorising significance in accordance with the SSMR.

On the macroprudential side, Bulgarian and Croatian banks will now be open to scrutiny by the ECB, which may request them to adopt or increase levels of capital and liquidity for the purposes of managing macroprudential risks. Both countries had taken a more precautionary approach of designating a larger number of banks as O-SIIs, and so domestically significant: all banks under the indirect supervision of the ECB are designated as O-SIIs in Bulgaria and all but three banks in Croatia. The case of Croatia suggests the importance that the ECB attaches to other aspects of determining significance, such the relevance of cross-border activity, when deciding the categorisation of banks.

With close cooperation, decision-making about resolution shifts from the NRA to the SRB, with the practical execution of the resolution scheme still residing with the former. It is argued that the SRB's relationship with member states in close cooperation within the SRM is therefore "equivalent" rather than "comparable", as with the ECB in the SSM. A critical feature is the mutualisation of assistance through the SRF, including the possibility of a backstop credit line from the ESM. A country entering close cooperation has to merge its national resolution fund into that shared by existing Banking Union members. This reduction of autonomy is offset by access to a larger pool of funds and direct involvement in decision-making about the parent groups of significant banks in Bulgaria and Croatia via participation in the SRB.

Bulgaria's and Croatia's experience with close cooperation and abidance by the ERM II will be closely studied by other non-euro EU countries and by the ECB. The experience of these two leaders may be of greatest interest to aquis countries that are members of the EU, whose banking systems are largely dominated by euro-area banks, and which may aspire to eventual membership of the EMU and the Banking Union.

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