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**<Heading Level One> Incentive-Compatible Relationship between 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 explicitly include the simultaneous joining of the Exchange Rate Mechanism (ERM II). It now appears entry into ERM II requires entry into the Banking Union. 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 ERM II and the Banking Union? 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.

Keywords: Banking Union, Close Cooperation, ERM II

JEL Classification: E02, E44, F15, G15, G21, H12, K23

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“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 Juncker¹

<Heading Level One> 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.² This safeguards the integrity of monetary union by having in place, inter alia, effective bank prudential supervision and resolution as part of a move towards further European integration.

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 euro-area

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> (accessed 10 September 2020).

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 Feature 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 Paper 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).

countries, with the Single Supervisory Mechanism (SSM),³ the Single Resolution Board (SRB) and the commitment to complete the Banking Union.⁴

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).⁵ 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.⁶ 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 SSM Regulation, in the cases of both Bulgaria and Croatia the ECB Governing Council announced the inclusion of their respective currencies in ERM II. In parallel, therefore, a prior commitment to enter ERM II is entry into “close cooperation” in the

³ 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 the SSM Regulation).

⁴ Regulation (EU) No 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 the SRM Regulation).

⁵ Henceforth we refer to both the Single Supervisory Mechanism and the Single Resolution Board as the Banking Union.

⁶ SRM Regulation Recital 15.

Banking Union with their respective central banks following the fulfilment of the necessary supervisory and legislative prerequisites. The move towards greater monetary integration requires banking supervision that is considered to be fit for purpose for the existing and ensuing cross-border financial flows between the respective groups of countries. Together, these two steps pave the way for Bulgaria's and Croatia's future participation in the euro area.

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 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? What are the benefits for those two Member States participating in ERM II of requiring entry into close cooperation in the Banking Union? Does the integration of close-cooperation countries' banking systems with the euro-area banking systems support the decision to join 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 attempts to bridge the gap in the literature on "close cooperation" in the Banking Union by exploring the rationale behind the simultaneous entry into ERM II and the Banking Union by Bulgaria and Croatia. It also reflects on the wider benefits of participating in the two mutualisation funds, the Single Resolution Fund (SRF) and the European Stability Mechanism (ESM), aimed at addressing the weaknesses exposed by the global financial crisis because of the nexus between sovereigns and banks.⁷

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. The simultaneous joining of the two requires evidence of "suitability" before applications can be approved. Section 3 presents a characterisation of the two banking systems in the EU non-euro-area countries (Bulgaria and Croatia) that applied to join ERM II, emphasising the importance of the presence of euro-area banks. It is suggested that the present level of financial integration is likely to become even closer and deeper in ERM II. Section 4 analyses cooperation in normal times during the "close-cooperation" period: cooperation in microprudential and macroprudential supervision while fulfilling the nominal

⁷ Maria J Nieto, "Bank Resolution and Mutualization in the Euro Area" *European Economy, Banks, Regulation, and the Real Sector* 2016-2 (September).

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.

<Heading Level One> 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 relevant central banks following the fulfilment of the necessary supervisory and legislative prerequisites. In parallel, the inclusion of their respective currencies in ERM II was announced.⁸ Together, these two steps pave the way for Bulgaria's and Croatia's future participation in the euro area.⁹

“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.”¹⁰

⁸ 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 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 ERM with its existing currency board arrangement in place as a unilateral commitment, thus putting no additional obligations on the ECB.

⁹ “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 is 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”.

¹⁰ 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 Eurogroup president explicitly

The decision by Bulgaria and Croatia to apply to enter ERM II and the commitment to enter the Banking Union need to be put into context to understand better the rationale of combining the two decisions. Equally, it is important not to overlook the fact that this decision resides in the original commitment of both countries to participate in the EMU as Member States with a derogation because, at the time of joining the EU, they both did not fulfil the conditions for adopting the euro and have not done so to this day.¹¹ As part of the original commitment by Bulgaria and Croatia to the EMU, the Commission and the ECB are required to report at least once every two years to the Council on the progress each Member State has made towards achieving the appropriate degree of sustainable convergence in line with four criteria: the achievement of a high degree of price stability; sustainability of the government's financial position; observance of the normal fluctuation margins in the ERM; and management of long-term interest rates in the ERM.¹² While it is beyond the scope of this paper to expand on those criteria, the technical criterion is broad in terms of its practical application and interpretation, with various economic and monetary policy indicators assessed to gauge whether Member States are on course to attain sustainable economic and monetary goals that are not going to threaten the stability of the euro.¹³ To this end, the convergence reports provide an assessment of technical compliance with the respective convergence criteria. While the convergence criteria do not specifically include reference to participation in the Banking Union, they nevertheless implicitly reflect the importance of having effective prudential supervision to strengthen sustainability of price stability and public finance in the monetary union.¹⁴ The experience of the financial crisis led to a reconsideration of the policy of entering ERM II to ensure Member States can withstand the shocks of potential economic crises in the future. Hence in July 2018, following Bulgaria's application to join ERM II, the parties agreed that new Member States entering ERM II must comply with the "reinforced approach", including commitments to "institutional quality, governance, the financial sector, fiscal policy, or the business

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. 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).

¹¹ Article 139(1) TFEU. See specifically the conclusions reached in the European Commission Convergence Report 2020, Institutional Paper 129, June 2020, at p.7 and p.12 respectively <https://ec.europa.eu/info/sites/default/files/economy-finance/ip129_en.pdf> (accessed 12 August 2021). (hereinafter Convergence Report 2020).

¹² Article 140 TFEU; these are further elaborated in Protocol No.13 TFEU. For further analysis of price stability see Fabian Amtenbrink and Kees Van Duin, "The European Central Bank before the European Parliament: Theory and Practice after Ten Years of Monetary Dialogue" 34(4) E.L.Rev (2009) 561–583 at pp.572–581; Koen Lenaerts, "EMU and the EU's Constitutional Framework" 39(6) E.L.Rev (2014) 753–769.

¹³ Alicia Hinarejos, *The Euro Area Crisis in Constitutional Perspective* (Oxford University Press 2015).

¹⁴ Convergence Report 2020.

environment”.¹⁵ Nonetheless, in an examination of additional criteria referred to in art.140(1) TFEU, Lastra and Louis highlight: “The progress achieved in market integration is analysed in relation to the structures and tendencies of the financial sector and respect for the *acquis communautaire* in this field.”¹⁶

The different pillars explored in the sections below help new members of ERM II to withstand and better manage financial crises, with the introduction of centralised supervision, resolution and access to mutualised financial support via the Single Resolution Fund and the European Stability Mechanism. A strengthened financial institutional framework minimises the economic and fiscal impact of financial crises. Based on this rationale, it is not surprise that Bulgaria and Croatia in their letters to, *inter alia*, the President of the Eurogroup committed to enter ERM II and join the Banking Union as well.¹⁷ In the decision-making process it is important to analyse the role of the Eurogroup in both areas.

The Eurogroup¹⁸ plays an important role in the decision-making of the European Union, with its specific mandate to develop “ever-closer coordination of economic policies within the euro area”,¹⁹ and outside its formal Treaty mandate it contributes to the accountability of the ECB in the way it undertakes its tasks in the SSM.²⁰ In view of the fact that it represents the euro Member States, it is also one of the parties that decides the entry into ERM II. Servais and Rugger argue that “the Protocol [(No.14)] gives a legal basis to an existing body [Eurogroup],

¹⁵ Convergence Report 2020 at p. 35. This could be considered controversial, as the underlying principle for adopting the euro, as explained by “the European Council, at its Madrid session of 15–16 December 1995” is one of Member States being treated equally to those Member States participating in 1998. See Rosa M Lastra and Jean Victor Louis, “European Economic and Monetary Union: History, Trends, and Prospects” 32 *Yearbook of European Law* (2013) 57–206 at p.77.

¹⁶ Lastra and Louis, “European Economic and Monetary Union” at p.82

¹⁷ Eurogroup statement and remarks: Statement on Bulgaria’s path towards ERM II participation, 12 July 2018 <<https://www.consilium.europa.eu/en/press/press-releases/2018/07/12/statement-on-bulgaria-s-path-towards-erm-ii-participation/>> (accessed 12 August 2021); Republic of Bulgaria Ministry of Finance, Letter on ERM II participation to President of the Eurogroup, President of the European Central Bank, Finance Ministers of the Euro Area Member States, Finance Minister and Central Bank Governor of Denmark, Vice President of the European Commission for the Eurogroup; Statement on Croatia’s path towards ERM II participation, 8 July 2019, <<https://www.consilium.europa.eu/en/press/press-releases/2019/07/08/statement-on-croatia-s-path-towards-erm-ii-participation/>> (accessed 12 August 2021); Republic of Croatia Ministry of Finance, Letter on ERM II participation to President of the Eurogroup, President of the European Central Bank, Finance Ministers of the Euro Area Member States, Finance Minister and Central Bank Governor of Denmark, Vice President of the European Commission for the Euro, 4 July 2019 <<https://www.consilium.europa.eu/media/40282/letter-of-intent.pdf>> (accessed 12 August 2021).

¹⁸ Article 137 TFEU.

¹⁹ Protocol No.14 TFEU.

²⁰ SSM Regulation Recital 55.

which has become the place where the euro area Member States can discuss issues that are then (only) formally decided upon in the Council”.²¹

Craig and Markakis go further to explain that the Eurogroup is not conferred with responsibilities of a legal binding nature, but contributes to the preliminary discussions that require, inter alia, Council decisions.²² Nonetheless, they highlight:

“[The] Eurogroup, and especially the President, is central to all major initiatives relating to the euro area, broadly conceived, which cover structural adjustment, macro-economic planning, negotiation with states in receipt of aid pursuant to agreements made with bodies such as the ESM, and aspects of banking union.”²³

In part, this explains the political nature of the decision taken by Bulgaria and then applied to Croatia when they both applied to enter ERM II, and the Banking Union. The Eurogroup “stressed that we [Eurogroup] expect to follow a similar approach for Member States wishing to join ERM II in line with the principle of equal treatment”.²⁴ Hence this is a “political expectation” that has no formal legal basis but does have a political and economic rationale.

The Resolution of the European Council 1997 does not provide a specific procedure for entering ERM II.²⁵ In view of the voluntary nature of entry,²⁶ it is incumbent on “all parties” (the finance ministers of euro area Member States, the ECB and the current non-euro areas participating Member States at the time, and the central bank governor of Denmark) to agree on the central rates and standard fluctuation bands.²⁷ We should bear in mind that the requirement to join

²¹ Dominique Servais and Rodolphe Ruggier, “The EU Constitution: Its Impact On Economic and Monetary Union and Economic Governance” in ECB, Liber Amicorum Paolo Zamboni Garavelli, *Legal Aspects of the European System of Central Banks*, 2005 at p.63.

²² Paul P. Craig and Menelaos Markakis, “The Euro Area, Its Regulation and Impact on Non-Euro Member States (March 2, 2016). Panos Koutrakos and Jukka Snell (eds), *Research Handbook on the Law of the EU’s Internal Market* (Edward Elgar, 2017) ch 14, Oxford Legal Studies Research Paper No.11/2016, SSRN: <https://ssrn.com/abstract=2741211>, at p.4.

²³ Craig and Markakis, “The Euro Area, Its Regulation and Impact on Non-Euro Member States” at p.5.

²⁴ Eurogroup statement and remarks, 12 July 2018: Statement on Bulgaria’s path towards ERM II participation <<https://www.consilium.europa.eu/en/press/press-releases/2018/07/12/statement-on-bulgaria-s-path-towards-erm-ii-participation/>> (accessed 5 August 2021).

²⁵ Kirsten Rohde Jensen, “Inside EU, Outside EMU: Institutional and Legal Aspects of the Exchange Rate Mechanism II” in European Central Bank, *Legal Aspects of the European System of Central Banks*, Liber Amicorum Paolo Zamboni Garavelli, 2005, 135–146 at p.140.

²⁶ Resolution June 1997 para.1.6; European Central Bank 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/C 73/08).

²⁷ Resolution June 1997 para. 2.3; ERM II – the EU’s Exchange Rate Mechanism <https://ec.europa.eu/info/business-economy-euro/euro-area/introducing-euro/adoption-fixed-euro-conversion-rate/erm-ii-eus-exchange-rate-mechanism_en#joining-erm-ii> (accessed on 06/08/21)

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 ERM II.²⁸ In view of the purpose of ERM II, Neergaard refers to it as a “waiting room” to ensure the transition to adopting the euro is as smooth as possible.²⁹ Indeed, the combination of participating in ERM II and the Banking Union in this two-track “interim phase” places the future expansion of the euro area on a more sustainable footing by overseeing the increased financial flows between the two groups and reducing the risks of financial instability.³⁰ The arrangement benefits from post-crisis reforms to address the threats of “asymmetric shocks” between banks and sovereigns, and so reduce the likelihood of state bailouts.³¹

The European Commission and the ECB are given the responsibility by the “ERM II parties” in line with their respective competencies to monitor Bulgarian and Croatian efforts to introduce the prior commitments in the form of specific legislative and policy changes before entering ERM II.³² The convergence criteria, as noted above, are wide and ERM II is simply one criterion in eventual adoption of the euro.³³ However, the significance of exchange rate management is how economic and monetary factors can influence fluctuations within the respective bands. In view of this, the prior commitments are wide to ensure a high level of economic and monetary sustainability. Equally, the respective commitments also relate to improving other areas beyond bank supervision and crisis management, such as market integrity and non-banking sector regulation and supervision. For instance, Bulgaria introduced reforms within the Commission competency of assessment in the supervision of the non-banking financial sector, the insolvency framework, the anti-money-laundering framework and the governance of state-owned enterprises. Croatia introduced reforms within the Commission competency of assessment to the anti-money-laundering framework, the collection, production

²⁸ Kirsten Rohde Jensen, “Inside EU, Outside EMU”.

²⁹ Ulla Neergaard, ERM II, in Fabian Amtenbrink and Christoph Herrmann (eds), *The EU Law of Economic and Monetary Union* (Oxford University Press, 2020) p.739. See also Jörn Piskorn, “Legal Arrangements in the Treaty of Maastricht for the Effectiveness of the Economic and Monetary Union”, 31(2) C.M.L. Rev. (1994) 263–291. For an examination of the role of the ESCB and ECB in banking supervision, see René Smits, “The Role of the ESCB in Banking Supervision” in European Central Bank, *Legal Aspects of the European System of Central Banks*, Liber Amicorum Paolo Zamboni Garavelli, European Central Bank, 2005, 198–212.

³⁰ European Commission, Economic Review of the Financial Regulation Agenda, Commission Staff Working Document, Ch. 1–4, SWD (2014) 158 final at p.14.

³¹ Alicia Hinarejos, *The Euro Area Crisis in Constitutional Perspective* (Oxford University Press, 2015) at pp.61–63. See Menelaos Markakis, *Accountability in the Economic and Monetary Union Foundations, Policy, and Governance* (Oxford University Press, 2020) pp.116–118.

³² Commission letter and accompanying Staff Working Document on the implementation of Bulgaria’s prior commitments 3–6, 10 July 2020 <https://ec.europa.eu/info/sites/default/files/economyfinance/com_opinion_on_bg_erm-ii.pdf> (accessed 5 August 2021); Commission letter and accompanying Staff Working Document on the implementation of Croatia’s prior commitments, 10 July 2020 <https://ec.europa.eu/info/sites/default/files/economy-finance/com_opinion_on_hr_erm-ii.pdf> (accessed 5 August 2021).

³³ Lastra and Louis, “European Economic and Monetary Union” at p.88.

and dissemination of statistics, public sector governance and the financial and administrative burden on enterprises. Both Bulgaria and Croatia introduced reforms overseen by the ECB to improve the macroprudential supervision toolkit to mitigate excessive growth and leverage in the credit market by introducing loan-to-value limits and loan-to-income limits, for instance.³⁴ The Commission and the ECB are invited by the respective Member States to assess their reforms and report the findings to the “ERM II parties”. While these new prior commitments are viewed as political hurdles to slow down the adoption of the euro, the need for them to ensure a stable financial system is nonetheless an important precondition with which all euro Member States are expected to comply.³⁵

The exchange rate mechanism provides the administrative framework for the currencies of Bulgaria and Croatia to be aligned with the euro within negotiated margins for at least two years. Lastra defines the mechanism as a “parity grid of bilateral exchange rates, with interventions limiting the swings in currency prices between pre-announced floors and ceilings”.³⁶ In this way, Jensen says, “the euro would thus be the hub of the system, while the non-euro currencies would constitute the spokes”.³⁷ A standard fluctuation band of plus or minus 15 per cent is stipulated in the 1997 Resolution.³⁸ The fluctuation band is not limited to the standard range – for instance, the Danish kroner observes a narrow fluctuation band of plus or minus 2.25 per cent.³⁹ ERM II consists of three key principles:

- 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) [to] provide a reference for their conduct of sound economic policies in general and monetary policy in particular; and

³⁴ ECB, Bulgaria – assessment of ERM II prior commitment No.2 on the macroprudential toolkit, 3 July 2020

<https://www.ecb.europa.eu/pub/pdf/other/ecb_assessment_bulgaria_erm_II~42b06fb4e2.en.pdf?fe0dc3cab527bacea8ac3b6b0a66a549> (accessed 5 August 2021); ECB, Croatia – assessment of ERM II prior commitment No.2 on the macroprudential toolkit, 3 July 2020

<https://www.ecb.europa.eu/pub/pdf/other/ecb_assessment_croatia_erm_II~f51d3b0a22.en.pdf?9fd4ef0c06ba8b19524681ef90de46bd> (accessed 5 August 2021).

³⁵ Mojmir Hampl, Euro Area Humiliates Bulgaria, 12 September 2018; See IMF, Bulgaria Financial System Stability Assessment – Press Release; Staff Report; and Statement by the Executive Director for Bulgaria, IMF Country Report No. 17/132 at pp.2–3.

³⁶ Rosa M Lastra, *International Financial and Monetary Law* (Oxford University Press, 2015) at p. 228.

³⁷ Kirsten Rohde Jensen, “Inside EU, Outside EMU” p.138.

³⁸ Resolution of the European Council on the establishment of an exchange-rate mechanism in the third stage of economic and monetary union, Amsterdam, 16 June 1997, para.2.1.

³⁹ Resolution para.1.8.

iii) [to] protect non euro area Member States from unwarranted pressures in the foreign-exchange markets.⁴⁰

Hence participation in 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.⁴¹ It should be noted that the currencies of Bulgaria and Croatia were already closely tied to the euro at the time of applying to 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 1997.⁴² Croatia had a peg first with the deutschmark, and from 1999 to the euro, with a narrow band. All the countries that joined ERM II have become members of the EMU,⁴³ with the sole exception of Denmark, which opted out of the obligation to become a member by virtue of Protocols Nos 15 and 16.⁴⁴ Denmark fulfils the convergence criteria and could adopt the euro, but remains in ERM II until it decides to change its political position on entry.

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 ERM II to have simultaneous close cooperation with the 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 Union. In turn, participation in the Banking Union requires a period of close cooperation with the ECB in the

⁴⁰ 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; 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 cooperation see Svend E Hougaard Jensen and Dirk Schoenmaker, “Should Denmark and Sweden Join the Banking Union?” 6(2) *Journal of Financial Regulation* (2020) 317–326.

⁴¹ 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 (hereinafter ERM II Central Bank Agreement).

⁴² For an examination of Bulgaria’s experience in the currency board and entering ERM II see Kristina Dimitrova and Michael Huertas, “Bulgaria – The Eurozone Hopeful Country and Its Currency Board” 35(9) *Journal of International Banking Law and Regulation* (2020) 371–379.

⁴³ Since the inception of the euro the following members states have joined 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, list of amendments <<https://www.ecb.europa.eu/ecb/legal/107663/1350/html/index.en.html>> (accessed 30 June 2020).

⁴⁴ 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).

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 ERM II deals with the “efficiency” gaps in the pre-existing arrangements that neglect the possibility of negative bank sovereign “loops”.⁴⁵ Against this background, as is the case for ERM II, the “participation” mechanism should be understood as a binding requirement of a temporary nature until the applying country joins the EMU.

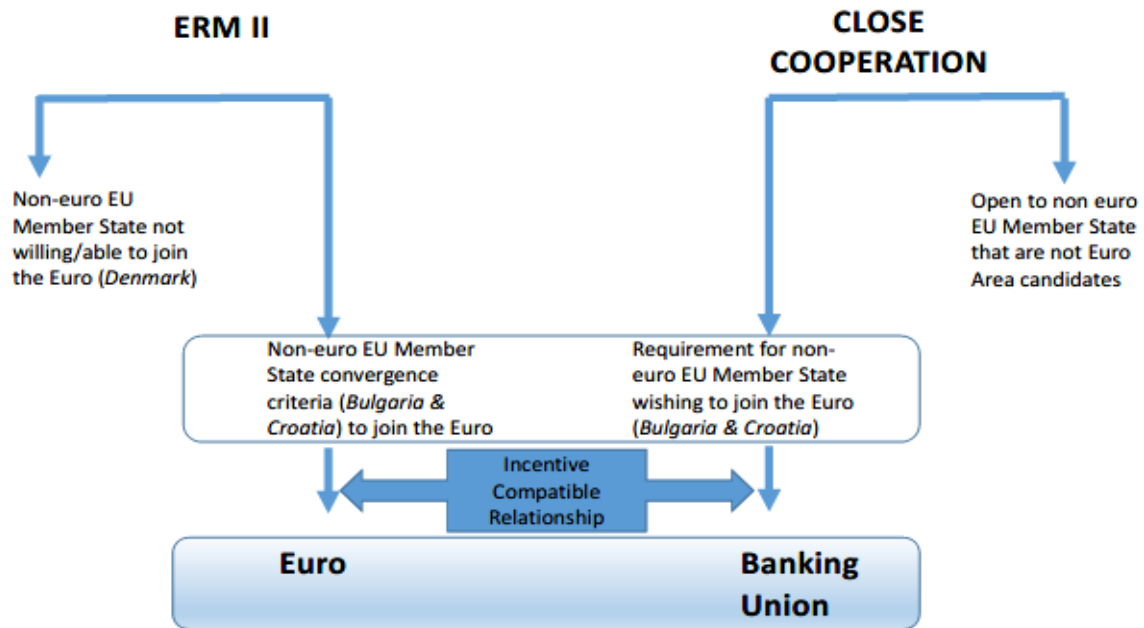
In this context, the binding and temporary nature of the close-cooperation mechanism highlights a particular case of the bespoke general governance arrangements of art.7 of the SSM Regulation, in which the possibility of “opting out” fades with the incentives for joining the euro.⁴⁶ Article 7 and its modalities (set out primarily in the 2014 SSM Framework Regulation and the 2014 ECB Close Cooperation Decision⁴⁷) 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 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.

Figure 1

⁴⁵ 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.

⁴⁶ The SSM was established by Council Regulation (EU) 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions [2013] OJ L287, 63 (hereinafter the SSM Regulation). Close cooperation is elaborated further in Regulation (EU) 468/2014 of the European Central Bank of 16 April 2014 establishing the framework for 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 the 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.

⁴⁷ SSM Framework Regulation.



Source: Authors' analysis

<Heading Level One> The features of the banking systems when applying to the EMU⁴⁸

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 ERM II to join the euro and 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 information asymmetries and limit the risks of contagion from cross-border banking.⁴⁹

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

⁴⁸ Bulgaria became a member of the EU on 1 January 2007, while Croatia was the latest to join on 1 July 2013.

⁴⁹ 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).

limited size of domestic banks (as was the case in both Bulgaria and Croatia).⁵⁰ Table 1 shows the important presence of EU banks, mostly in the form of subsidiaries, in Bulgaria and Croatia.

⁵⁰ Ismael Ahmed Fontán, Thorsten Beck, Katia D’Hulster, Pamela Lintner and D. Filiz Unsall, “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)⁵¹

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

⁵¹ 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).

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.

Dorrucci and colleagues show that following the accession of countries to the EU, countries that participated in ERM II in 2004 and 2005 experienced a more pronounced international financial flow cycle than those which did not participate. Gross financial inflows as a share of GDP accelerated ahead of EU accession, which for some countries also coincided with the start of their participation in ERM II.⁵² However, countries that joined ERM II experienced a much stronger surge. Gross financial inflows in ERM II participating countries peaked about three years after they joined ERM II, and were driven largely by bank lending to corporates and households, interbank lending between branches and subsidiaries of EU banks and, to a lesser extent, inward foreign direct investment. Financially less-developed ERM II participating countries generally have lower domestic savings and therefore need financing from abroad to support economic growth and real as opposed to nominal convergence with the euro area – this may pose a challenge for certain countries joining ERM II, as large international financial inflows are likely to fuel credit booms and busts. Hence the rationale of a prior commitment to entering ERM II: this is entry into “close cooperation” following the fulfilment of the necessary supervisory and legislative prerequisites.

As per the ECB choice of significant banks for the purpose of close cooperation in supervision, the ECB-designated significant banks are all foreign subsidiaries of euro-area banks in Bulgaria and Croatia.

In Croatia, 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

⁵² Ettore Dorrucci, Michael Fidora, Christine Gartner and Tina Zumer, “The European Exchange Rate Mechanism (ERM II) as a Preparatory Phase on the Path towards Euro Adoption – The Cases of Bulgaria and Croatia”, ECB Economic Bulletin, Issue 8/2020.

banking sector to the real economy is comparatively limited – although a disorderly bank crisis could well morph into a systemic crisis.

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

	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)⁵³

⁵³ 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 are set out in the SSM Regulation,⁵⁴ 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:

- 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 bank's 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 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 – 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.⁵⁵ 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 2018.⁵⁶

The ECB, however, exercised its discretion in accordance with art. 6(5)(b) of the SSM Regulation to bring into direct supervision a number of less significant banks that operate in Bulgaria and Croatia.⁵⁷ In this category, the size of the bank in comparison to total assets is not

⁵⁴ Article 6(4)(i)–(iii) SSM Regulation.

⁵⁵ The ECB lists Bulgarian and Croatian banks it will directly supervise as of October 2020 <<https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200911~882a53b229.en.html>> (accessed 20 September 2020).

⁵⁶ Article 7(1) of SSM Regulation and Article 107(3) of SSM Framework Regulation.

⁵⁷ Article 6(5)(b) of SSM Regulation and Article 67 of SSM Framework Regulation. The ECB (11 September 2020) lists Bulgarian and Croatian banks it will directly supervise as of October 2020. For a detailed analysis of the Banking Union see Danny Busch and Guido Ferrarini, *European Banking Union* (Oxford University Press 2020).

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.⁵⁸ However, 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 six times, and in most of those instances the banks are US institutions with multiple entities in the euro area.⁵⁹ 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.⁶⁰ 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 to 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.⁶¹ 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.⁶² 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.⁶³ 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

⁵⁸ Argyro Karagianni and Miroslava Scholten, “Accountability Gaps in the Single Supervisory Mechanism (SSM) Framework” 34(2) *Utrecht Journal of International and European Law* (2018) 185–194; Filippo Annunziata, “European Banking Supervision in the Age of the ECB: Landescreditbank Baden-Württemberg – Förderbank v. ECB” 21 *European Business Organization Law Review* (2020) 545–570. See also Tobias Tröger, “A Political Economy Perspective on Common Supervision in the Eurozone”, in Ester Faia, Andreas Hackethal, Michael Haliassos and Katja Langenbucher (eds) *Financial Regulation: A Transatlantic Perspective* (Cambridge University Press, 2015) 167–192.

⁵⁹ ECB list of supervised entities, 1 July 2020.

⁶⁰ 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.

⁶¹ Commission Decision of 29 April 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 <https://ec.europa.eu/competition/state_aid/cases/248556/248556_1563415_75_3.pdf> (accessed 10 September 2020).

⁶² In Slovenia and Croatia the subsidiaries of Adikko Bank are ranked tenth and eighth by total assets, but their proportion of group assets mean they are significant to the group.

⁶³ Annex I: Revised list of other cross-border groups, 6 October 2020 <<https://srb.europa.eu/en/content/banks-under-srbs-remit>> (accessed 15 October 2020).

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.

<Heading Level One> 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.⁶⁴ 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 and more recently by Pistor.⁶⁵ 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. This aggravates the potential negative consequences of credit booms that can turn out to be more severe and difficult to contain in countries with fixed exchange rates in the context of the ERM II application, as the rising inflation typically associated with strong domestic demand lowers real interest rates further, and this in turn triggers additional credit demand. The requirement to enter close cooperation attempts to address information asymmetries and the lack of incentive to cooperate among host and home authorities by moving powers for financial policies (regulation, supervision and stability) further to the European level. It is now evident that the relationship

⁶⁴ Richard Herring, “Conflicts between Home and Host Country Prudential Supervisors”, in Douglas Evanoff, George Kaufman and John Raymond LaBrosse (eds), *International Financial Stability: Global Banking and National Regulation* (World Scientific, 2007), 201–220.

⁶⁵ Richard Herring, “Conflicts between Home and Host Country Prudential Supervisors”. 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; Emiliós Avgouleas, *Governance of Global Financial Markets: The Law, the Economics, the Politics* (Cambridge University Press, 2012) 422–423.

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.⁶⁶

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.⁶⁷ In this relationship, the close-cooperation countries enact legislation to share the responsibility of supervision and resolution with the ECB and SRB.⁶⁸ 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.⁶⁹ 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.⁷⁰ Article 7 gives the ECB the authority to change macroprudential capital and liquidity buffers, but the national designated authority (NDA) retains the power to decide which banks are designated as national systemically important

⁶⁶ ECB Framework Regulation Art 107(2); Dalvinder Singh, *European Cross Border Banking and Banking Supervision* (Oxford University Press, 2020), 33.

⁶⁷ 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).

⁶⁸ SRM Regulation Art. 18(1).

⁶⁹ Article 108(1)–(5) of SSM Framework Regulation ; 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). 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).

⁷⁰ Article 5 of SSM Regulation.

institutions. 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 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 and its direct authority over the NCAs and NDAs; 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.⁷¹

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.⁷² NCAs then adopt national administrative measures or otherwise execute the ECB’s instructions. As Moloney describes it, ECB decision-making is therefore intermediated.⁷³ 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.⁷⁴

The applicant Member State benefits from access to the supervisory expertise of joint supervisory teams (JSTs), thus essentially hiring the credibility of the SSM.⁷⁵ The credibility of

⁷¹ Articles 107(2) and 118–119 of SSM Framework Regulation; Article 7(5)–(8) of SSM Regulation; Article 6 of Decision ECB/2014/5.

⁷² Article 108 of SSM Framework Regulation.

⁷³ Niamh Moloney, “Close Cooperation: The SSM Institutional Framework and Lessons from the ESAs” in ECB, *Building Bridges: Central Banking Law in an Interconnected World* (ECB Legal Conference, Frankfurt, December 2019).

⁷⁴ 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.

⁷⁵ Rosa Lastra, “Close Cooperation in the SSM”, in ECB, *Building Bridges: Central Banking Law in an Interconnected World* (ECB Legal Conference, Frankfurt, December 2019).

the NCAs will be boosted, as will the reputation of their banking systems.⁷⁶ 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 buttressing the ECB's authority. Finally, the SSM is broad in scope and also very large in size, allowing it to exploit economies of scale with regard to expert knowledge.⁷⁷

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:⁷⁸ 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 Regulation 468/2014.⁷⁹

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 ERM II).⁸⁰ 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.⁸¹ Moreover, the commitment to join the EMU minimises the authority risk for the ECB,

⁷⁶ Andrea Ernia, “The Institution of ‘Close Cooperation’ in the SSM: An Introduction”, in ECB, *Building Bridges: Central Banking Law in an Interconnected World* (ECB Legal Conference, Frankfurt, December 2019).

⁷⁷ Andrea Ernia, “The Institution of ‘Close Cooperation’ in the SSM”.

⁷⁸ Decision (EU) 2020/1015 (note 71 above) and Decision (EU) 2020/1016 (note 71 above).

⁷⁹ Regulation 468/2014 on establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities [2014] OJ L141.

⁸⁰ This is different from close cooperation when the countries have also applied to join ERM II, as is the case with Croatia and Bulgaria.

⁸¹ Zsolt Darvas and Guntram Wolf, “Should Non-Euro Area Countries Join the Single Supervisory Mechanism?” (2013) Bruegel Policy Contribution Issue 2013/06. See also Ansgar Belke, Anna Dobrzańska, Daniel Gros and Paweł Smaga, “(When) Should a Non-Euro Country Join the Banking Union?” (2016) 14 *Journal of Economic Asymmetries* 4; Zdenek Kudrna, “Governing the Ins and Outs of the EU’s Banking Union” (2016) 17 *Journal of Banking Regulation* 119; Katalin Mérő and Dóra Piroška, “Banking Union and Banking Nationalism – Explaining Opt-Out Choices of Hungary, Poland and the

as safeguards become insignificant and termination is a non-issue. Hence the incentive for simultaneous application to join ERM II and to enter close cooperation is apparent, as incentives for joining the EMU and being part of the Banking Union converge.

Czech Republic” (2016) 35 *Journal of Policy and Society* 215; Krystyna Mitreęa-Niestrój and Blandyna Puszer, “The Threats of the Banking Union for the Polish Banking Sector”, in *European Financial Systems 2015: Proceedings of the 12th International Scientific Conference* (Masarykova Univerzita, 2015) 400–407; Uwe Vollmer, “The Asymmetric Implementation of the European Banking Union (EBU): Consequences for Financial Stability” (2016) *International Journal of Management and Economics* 7.

<Heading Level One> The crisis management incentives for entering into close cooperation when applying to the 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 with asymmetry of information and the need to align incentives among safety-net regulators. This is particularly the case for countries with fixed exchange rates in the context of ERM II that are especially prone to credit booms and busts, as presented in Section 3.

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.⁸² The operation of close cooperation within the SRM will not differ much from the operation of the SRM within the euro area. Furthermore, as 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.⁸³ 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).⁸⁴ 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).⁸⁵ The common backstop will help to ensure that a bank failure does not harm the broader economy or cause financial instability.

⁸² 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.

⁸³ 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, and emergency liquidity assistance in Article 31.

⁸⁴ Opinion of the European Central Bank (CON/2019/16) (note 82).

⁸⁵ Agreement Amending the Treaty establishing the European Stability Mechanism, 27 January 2021 <https://www.consilium.europa.eu/media/48069/agreement-amending-the-treaty-establishing-the-european-stability-mechanism-27-january-2021_en.pdf?utm_source=dsms-auto&utm_medium=email&utm_campaign=Statement+by+the+Eurogroup+President%2c+Paschal+Donohoe%2c+on+the+signature+of+ESM+Treaty+and+the+Single+Resolution+Fund+Amending+Agreement>

The most debatable aspect of close cooperation, as in the Banking Union, is likely to be in the field of resolution decision-making.⁸⁶ The ECB decides whether a significant bank is failing or likely to fail, and the SRB decides how the bank will be resolved in either resolution or insolvency liquidation.⁸⁷ 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 and Croatia, domestic legislation was amended to this effect.⁸⁸ The reforms ensure the tasks and decisions of the NRA comply with the SRMR. The domestic legislative reforms extend to SRB decisions, guidelines and general instructions. In this respect, Ivana Parać Vukomanović, 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).⁸⁹ It is argued that 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.

ts> (accessed 27 January 2021); “Agreement Amending the Intergovernmental Agreement on the transfer and mutualisation of contributions to the SRF”, 27 January 2021

<[https://www.consilium.europa.eu/media/48068/agreement-amending-the-intergovernmental-agreement-on-the-transfer-and-mutualisation-of-contributions-to-the-single-resolution-fund-27-january-2021_en.pdf?utm_source=dsms-](https://www.consilium.europa.eu/media/48068/agreement-amending-the-intergovernmental-agreement-on-the-transfer-and-mutualisation-of-contributions-to-the-single-resolution-fund-27-january-2021_en.pdf?utm_source=dsms-auto&utm_medium=email&utm_campaign=Statement+by+the+Eurogroup+President%2c+Paschal+Donohoe%2c+on+the+signature+of+ESM+Treaty+and+the+Single+Resolution+Fund+Amending+Agreements)

auto&utm_medium=email&utm_campaign=Statement+by+the+Eurogroup+President%2c+Paschal+Donohoe%2c+on+the+signature+of+ESM+Treaty+and+the+Single+Resolution+Fund+Amending+Agreements

ts> (accessed 27 January 2021).
⁸⁶ Jens-Hinrich Binder, “Participation of Non-Euro Area Member States in the SRM: Centralized Decision-making, Decentralized Implementation – Shared Responsibilities”, in ECB, *Building Bridges: Central Banking Law in an Interconnected World* (ECB Legal Conference, Frankfurt, December 2019) 314–330.

⁸⁷ 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) 1093/2010.

⁸⁸ Law amending and supplementing the Law on Rehabilitation and Restructuring of Credit Institutions and Investment Intermediaries, Decree No. 103, 2 May 2019; The Act on the amendments to the Credit Institutions Act (Official Gazette No. 47/20).

⁸⁹ Ivana Parać Vukomanović, “Legal Challenges Related to Close Cooperation – Croatian Experience”, in Ivana Bajakić and Marta Božina Beroš (eds) *EU Financial Regulation and Markets: Beyond Fragmentation and Differentiation*, Conference Proceedings, 26–27 November 2020, Faculty of Law, University of Zagreb, 73.

The SRB in the SRM is reliant on the NRA to execute its resolution strategy.⁹⁰ 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.⁹¹ Disputes relating to these matters between the SRB and NRAs are open to appeal to the SRB Appeal Panel.⁹² The decision of the Appeal Panel is binding, and the disputed decision in question will need to be amended accordingly.⁹³

These responsibilities are specifically exercised over designated significant banks or those the ECB decides to supervise directly, and other SRB-designated cross-border groups.⁹⁴ 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 a Member State terminating close cooperation in the SSM and so also the SRM as a participating Member State.⁹⁵

Bulgaria and Croatia introduced domestic legislation to transfer and mutualise their resolution funds with the SRF.⁹⁶ Ratification of the Intergovernmental Agreement on the Single Resolution Fund (IGA)⁹⁷ opens the door for Bulgaria and Croatia entering into close cooperation.⁹⁸ Articles 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.⁹⁹ The IGA ceases to apply, in line with art. 7(2) of the SSM, once a Member State terminates close cooperation in the SSM.¹⁰⁰ The IGA provides reimbursement once a Member State no longer participates in the SSM, also in line with the SRMR.¹⁰¹ However, as explained

⁹⁰ Articles 7(1), 8 and 10 SRM Regulation.

⁹¹ Article 7(2) SRM Regulation.

⁹² Article 85 SRM Regulation.

⁹³ Article 85(7) SRM Regulation.

⁹⁴ Article 7(2)(a)(b) SRM Regulation.

⁹⁵ Article 7 SSM R; Article 4(2)(3) SRM Regulation.

⁹⁶ 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.

⁹⁷ Intergovernmental Agreement on the Transfer and Mutualisation of Contributions to the Single Resolution Fund (IGA) (2014) <<https://data.consilium.europa.eu/doc/document/ST%208457%202014%20INIT/EN/pdf>> (accessed 9 March 2021).

⁹⁸ Article 13 IGA.

⁹⁹ Article 8 IGA; Article 67(4) SRM Regulation.

¹⁰⁰ Article 12 IGA.

¹⁰¹ Article 15 IGA; Article 4(3)(a)–(c) SSMR.

above, the possibility of termination fades with the commitment to join the euro once Bulgaria and Croatia fulfil the convergence criteria.

The recent reforms to the ESM provide a separate backstop to the SRF if its resources are depleted by use in a bank resolution.¹⁰² The ESM amendment enables Member States entering close cooperation to contribute as participants. The amended treaty formalises the initiative of the Euro Summit of 29 June 2018 to provide a backstop to the SRF.¹⁰³ Member States in close cooperation are not contracting parties to the amending treaty, which remains exclusively for euro-area Member States, but the backstop adds 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 give 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 in the amended treaty enables those in close cooperation “to provide parallel credit lines for the SRF alongside the ESM”.¹⁰⁴ Participating Member States will be able to attend backstop-related meetings of the Board of Governors and Board of Directors of the ESM as observers.¹⁰⁵

<Heading Level Two> *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.¹⁰⁶ In Croatia the Croatian National Bank decides whether a bank enters resolution and the State Agency for Deposit Insurance and Bank Resolution is

¹⁰² 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 (25 March 2011) <https://www.esm.europa.eu/sites/default/files/20150203_-_esm_treaty_-_en.pdf> (accessed 1 March 2021).

¹⁰³ Agreement Amending the 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, the Republic of 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 (Amended ESM Treaty 2021).

¹⁰⁴ Recital 5 inserts Recital 9a, Amending ESM Treaty 2021.

¹⁰⁵ Article 6, Amending ESM Treaty 2021.

¹⁰⁶ International Association of Deposit Insurers, “Deposit Insurers’ Role in Contingency Planning and System-wide Crisis Preparedness and Management” (May 2019) Guidance Paper <https://www.iadi.org/en/assets/File/Papers/Approved%20Guidance%20Papers/IADI%20Guidance%20Paper_DI%20role%20in%20contingency%20planning%20&%20crisis%20management.pdf> (accessed 30 July 2020).

responsible for initiating a “loss-minimising” resolution strategy. Table 3 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.¹⁰⁷ The Croatian DGS submits an opinion if it needs to be involved in a resolution strategy.¹⁰⁸ In Bulgaria the central bank is the resolution authority and has the voting rights in SRB plenary and executive sessions.¹⁰⁹

The SRMR extends to the potential use of the national DGS in resolution for participating Member States.¹¹⁰ The DGS remains a national competency in accordance with the DGS Directive in view of the lack of a European Deposit Insurance System. 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.¹¹¹ In this respect, the Bulgarian Deposit Insurance Fund (BDIF) can provide financial assistance in the resolution of a bank by absorbing losses for insured depositors in the resolution process. For example, the powers the BDIF had to establish a bridge institution and an asset management vehicle in resolution were transferred to the Bulgarian central bank in a package of reforms prior to entering into close cooperation. The reforms also saw its responsibility for managing the resolution fund moved as well to the Bulgarian central bank with it ultimately being mutualised with the SRF.¹¹² 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.¹¹³ 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.¹¹⁴ 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

¹⁰⁷ Vukomanović, “Legal Challenges Related to Close Cooperation”, p. 74.

¹⁰⁸ Vukomanović, “Legal Challenges Related to Close Cooperation”, p. 74.

¹⁰⁹ Vukomanović, “Legal Challenges Related to Close Cooperation”, p. 74.

¹¹⁰ Article 79 SRM Regulation.

¹¹¹ Article 79(4) SRM Regulation.

¹¹² Section 56, para. 1 of the Transitional and Final Provisions of the Law on Amendment of the LRRCIIF (State Gazette, Issue 37, 7 May 2019).

¹¹³ 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).

¹¹⁴ The International Association of Deposit Insurers 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.

funding level and Bulgaria is only just below the target. In these cases the target level 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.¹¹⁵ 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 expects Member State DGSs to work together when a cross-border bank fails.¹¹⁶ 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 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.

¹¹⁵ Singh, *European Cross Border Banking and Banking Supervision*. The exception is Luxembourg – see Singh Appendix 6, Table 6.1.

¹¹⁶ European Parliament and Council Directive 2014/49/EU, 16 April 2014, on deposit guarantee schemes [2014] OJ L173/149.

Table 3: Comparison of safety nets

Safety-net characteristics	Euro-area significant banks	Croatia	Bulgaria
Resolution	SRB/SRF (no liquidation)	NCB decides on resolution ¹¹⁷	NCB is the resolution authority ¹¹⁸
DGS	Decentralised (some with resolution powers) and harmonisation by Directive Recast 2014 planned European Deposit Insurance System	DGS resolution powers (loss minimising)	DGS is only responsible for paying compensation
Emergency lending facility	NCBs (ECB, Agreement on ELA, 17 May 2017)	Central Bank of Croatia	Central Bank of Bulgaria (within limits of its foreign exchange holdings)

Source: Authors' analysis

¹¹⁷ 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).

¹¹⁸ According to Article 16.16 of the Law on the Bulgarian National Bank, the Bank Resolution Directorate is to specify the requirements and processes of preparation and approval of recovery plans and 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>(accessed 30 June 2020); Bulgarian National Bank, “Annual 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).

<Heading Level One> Conclusion

The goal of expanding participation in the European Banking Union was to allow the “outs” to enter into close cooperation, but it did not explicitly include the simultaneous joining of the Exchange Rate Mechanism (ERM II). It now appears that entry into ERM II requires entry into the Banking Union. 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 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 complying with close cooperation when applying to join ERM II 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 and the role those banks play in channelling the strong expansion of credit that goes hand in hand with participation in ERM II, as shown in the latest round of participation (Estonia, Lithuania, Slovenia, Latvia and Slovakia).

The strictness of the significance criteria does not lead to a potential position where 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 73.00 per cent respectively) is 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 foreign EU banks, since foreign EU banks in Bulgaria and Croatia have different ways of categorising significance

in accordance with the SSMR. 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. 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.

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 ERM II will be closely studied by other non-euro EU countries and the ECB. The experience of these two nations 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.