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Crisis management for euro-area banks in central Europe

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Executive summary

THE DEEP INVOLVEMENT of a number of euro-area banking groups in central and south-eastern Europe has benefitted the host countries and has strengthened the resilience of those banking groups. But this integration has become less close because of post-financial crisis national rules that require banks to hold more capital at home, or other ring-fencing measures. There is a risk integration might be undermined further by bank resolution planning, which is now gathering pace.

REGULATORS AND BANKS will need to decide between two distinct models for crisis resolution, and this choice will redefine banking networks. Most efficient in terms of preserving capital and the close integration of subsidiary operations would be if the Single Resolution Board – the banking union's central resolution authority – takes the lead for the entire banking group. However, this will require parent banks to hold the subordinated debts of their subsidiaries. Persistent barriers to intra-group capital mobility – or the option for home or host authorities to impose such restrictions – will ultimately render such schemes unworkable.

THE SECOND MODEL would involve independent local intervention schemes, which European Union countries outside the banking union are likely to call for. This will require building capacity in local debt markets, and clarifying creditor hierarchies. Exposure to banking risks will ultimately need to be borne by host-country investors. Bail-in capital issued by subsidiaries to their parents cannot be a substitute because it would expose the home country to financial contagion from the host.

TO SUSTAIN CROSS-BORDER linkages, banking groups and their supervisors will need to make bank recovery plans more credible, and to strengthen cooperation in resolution colleges (platforms that bring together all relevant parties in resolution planning and execution). Within the banking union there is no justification for the various ring-fencing measures that have impeded the flow of capital and liquidity within banking groups.

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1 Introduction

The adoption of a bank-resolution regime has been a key step in the European Union's quest to end taxpayer-funded bail outs and to quash the presumption that some financial institutions are too big to fail. Since 2015, the Single Resolution Board (SRB) has quickly established itself as the banking union's central resolution authority and has set per-bank targets for additional funding that could be subject to bail-in.

Under the 2019 revision to the EU Bank Resolution and Recovery Directive (BRRD), and the regulation governing the SRB, these targets for bail-in capital have been more accurately calibrated[1]. Requirements for the largest euro-area banking groups now closely resemble those for global systemically important banks (G-SIBs), which began resolution planning already in 2014 under the guidance of the Financial Stability Board (Bolton and Oehmke, 2018)[2]. Crucially, the new EU requirements for bail-in capital now also apply to the subsidiaries of cross-border banking groups. Since late 2019, the SRB has also begun to clarify which operational and legal obstacles to a possible resolution will need to be addressed by banks (SRB, 2019). This could usher in a major transformation for banking groups that have so far run integrated cross-border operations.

However, the bank-led plans for recovery from a crisis and the SRB's plans for resolution of institutions that have failed, re-open questions of how the international subsidiaries of euro-area banking groups would fare in a banking crisis in either the parent's home or a host country.

Nowhere is cross-border resolution planning more important than in central and south-eastern Europe[3]. The subsidiaries of euro-area banks in this region are typically systemically important within their respective host countries, though supervision and crisis planning will depend on close cooperation with the authorities in the parents' home jurisdiction. Many vestiges of post-crisis ring-fencing persist in banking markets of both home and host countries, and continue to undermine this cooperation.

Planning for the resolution of a large euro-area cross-border banking group involves preparing for a worst-case scenario that might never come to pass, but must nevertheless be realistic. This Policy Contribution reviews the current state of financial engagement by euro area-based banking groups in the central and eastern Europe region (section 2). It then sets out in section 3 the two alternative models for bank resolution. Section 4 then proposes priorities for three groups of countries: host countries within the banking union, EU states outside the banking union, and non-EU countries. Each faces distinct challenges in resolution planning and engagement with the SRB. The concluding section 5 sets out options for how this cooperation can be strengthened by banks and the SRB itself.

1 See https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=OJ:L:2019:150:TOC. While the provisions in the capital regulation (CRR2) apply from the date of publication in June 2019, provisions in the directives (CRD5 and BRRD2) apply once transposed into national law by end-2020.

2 The G-SIBs that are subject to these earlier requirements for resolvability and that are based in the euro area are: Deutsche Bank, BNP Paribas, Crédit Agricole, ING Bank, Santander, Société Générale and UniCredit Group.

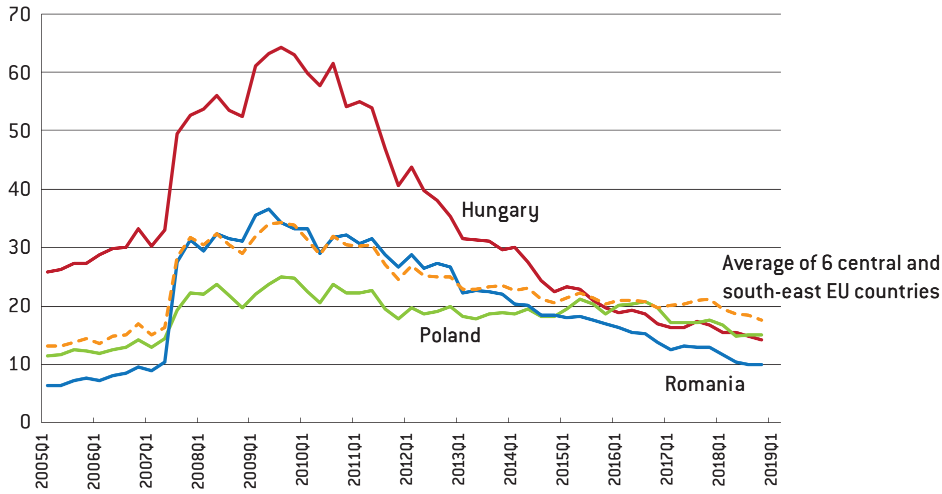
3 In this Policy Contribution, 'central and south-east Europe' refers to 11 countries that joined the EU between 2004 and 2011: the three Baltic countries, Poland, Hungary, the Czech Republic, Slovakia, Slovenia, Croatia, Bulgaria and Romania. Note the International Monetary Fund uses a wider definition of the central, eastern and south-east Europe country grouping.

2 Euro-area banking groups in central and south-eastern Europe

Up until the crisis of 2008-09, the deep financial integration fostered by the subsidiary networks of European cross-border banks in the central and south-east Europe region served the first phase of economic transition well. The presence of foreign-owned banks in the region's banking markets is more marked than in any other emerging-market region. Empirical evidence overwhelmingly points to benefits in terms of financial stability and overall growth[4]. However, such integration has also led to a number of vulnerabilities, for instance in the form of excessive lending in foreign currencies or to property sectors.

In the aftermath of the crisis, a sharp and protracted deleveraging of bank exposures set in between 2008 and 2016 (Figure 1). The reduction in cross-border bank funding in central and south-eastern European countries was particularly sharp compared to other emerging markets, though their financial systems were quickly stabilised by a number of International Monetary Fund programmes, such as in Latvia and Hungary. The Vienna Initiative, an essentially *ad-hoc* public-private forum, provided coordination between network banks, international institutions and home and host authorities. This effort succeeded in limiting liquidity outflows, which stabilised by about 2015, and limited imposition of ring-fencing strategies by host countries.

Figure 1: External positions of foreign banks towards EU countries in central and eastern Europe, % of GDP

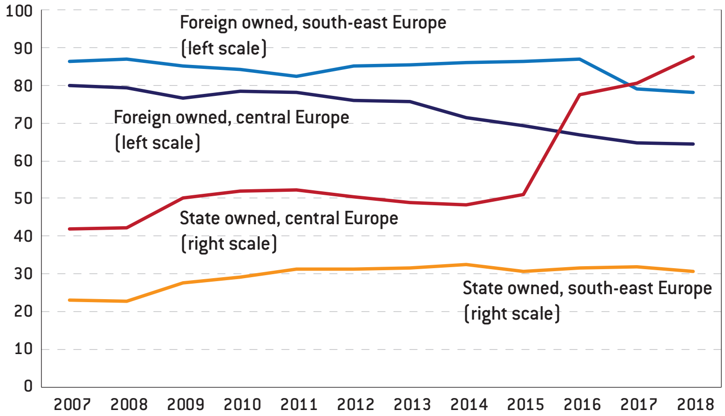


Source: BIS Locational Banking Statistics (2019Q1). Notes: Amounts outstanding/stocks of total claims on all instruments. Average of 6 countries refers to: Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania. Average is GDP weighted.

Since the financial crisis, a number of euro-area banking groups have withdrawn from the central and south-east Europe region, reflecting consolidation in their home markets. Foreign acquisitions of banks in the region have become rare. On the contrary, banking networks originating within the region have grown, most notably the Hungarian bank OTP. Nevertheless, the market shares of foreign-owned banks remain near their peak in south-eastern Europe (at 78 percent), though they have fallen by about 15 percentage points over the past ten years in the Czech Republic, Hungary, Poland and Slovakia (Figure 2). Overall, foreign ownership stakes have narrowed (and those of local state-owned banks expanded), though foreign networks remain largely intact.

4 See for instance EBRD (2009), which documented the growth effects of capital inflows.

Figure 2: Market shares of foreign- and state-owned banks in central and south-eastern European countries (% of total assets)



Source: Raiffeisen Research (July 2009). Notes: central Europe = Poland, Hungary, Czech Republic, Slovakia; southeast Europe = Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Kosovo, Romania, Serbia.

A significant number of banking groups based in the euro area, under ultimate European Central Bank supervision, continue to operate extensive subsidiary networks in central and south-east Europe. Banking groups from Austria, Italy and France are deeply engaged in markets that have turned out to be consistently profitable and which, since the financial crisis, have generated steady asset growth in excess of their euro-area home markets. Subsidiaries are typically significant within host markets, and are often also significant individually within the respective banking groups (Table 1 lists the largest groups with their respective host country market shares and the significance of individual subsidiaries in total group assets)[5].

Home-host cooperation in supervision and resolution planning will remain particularly complex outside the banking union, given two broad trends over recent years:

- First, funding models that previously relied on wholesale markets and parent-bank liquidity lines have become less risky because of a much greater reliance on local deposits, and in some countries on local debt markets (Figure 3 documents this increase in deposit-to-loan ratios). By funding themselves largely through local deposits, subsidiaries have become more decentralised and potentially amenable to local resolution schemes. Separation from the parent can now be foreseen, at least in financial terms.
- Second, euro-area authorities must confront a much greater scepticism on the part of local regulators about the financial-stability implications of foreign-bank presence. This has been evident in preferential treatment for local banking champions, and in some instances through explicit goals of increasing domestic ownership in the sector.

EU banks' withdrawal from international exposures following the financial crisis appears to have been much sharper than that of cross-border banks from other regions, such as Japan or the United States (McCauley *et al*, 2017).

Despite the strengthening of bank balance sheets, financial integration in the EU has not markedly recovered since the crisis. ECB assessments show that a composite indicator of financial integration within the euro area based on price measures has recovered, though it remains below pre-crisis levels. An indicator based on the extent of cross-border exposures has continued to decline (European Commission, 2019). Figure 4 shows the external claims of euro-area banks on six central European countries and on other countries in the currency area, and shows that these have been closely aligned.

5 Based on RBI (2019), the dominant banking groups in central Europe are Erste Bank of Austria, KBC, Santander, Unicredit, SocGen, RBI, Commerzbank, ING, BNP, Intesa and Millennium Bank. In addition, Slovenian bank NLB and Greece's Eurobank operate in the south-east Europe region.

Table 1a: Share of euro-area banks' subsidiaries in host country total banking assets (%), 2017

		Erste	Intesa	KBC	Nordea	Raiffeisen	Société Générale	UniCredit	Euro-area banks*
Non-euro area EU	Bulgaria			8.2%		8.1%	7.8%	22.7%	62.9%
	Croatia	15.0%	23.7%			7.8%		28.9%	75.8%
	Czech Rep.	11.1%		11.6%		5.4%	8.6%	8.6%	85.8%
	Hungary	2.4%	5.1%	9.1%		6.6%		8.3%	38.5%
	Poland					3.3%	0.9%		52.7%
	Romania	9.5%	1.1%			9.4%	14.0%	11.2%	65.0%
Euro-area	Estonia				14.2%				14.2%
	Latvia				17.2%				18.1%
	Lithuania				27.1%				27.1%
	Slovakia	23.7%	21.7%	13.4%		18.1%		7.3%	89.3%
	Slovenia		6.8%				9.0%	7.8%	37.5%
Non-EU	Albania		12.1%			16.9%	5.5%		43.8%
	N. Macedonia						8.3%		52.5%
	Montenegro	14.1%					13.9%		41.3%
	Serbia	4.6%	15.4%			7.3%	8.0%	10.1%	61.0%

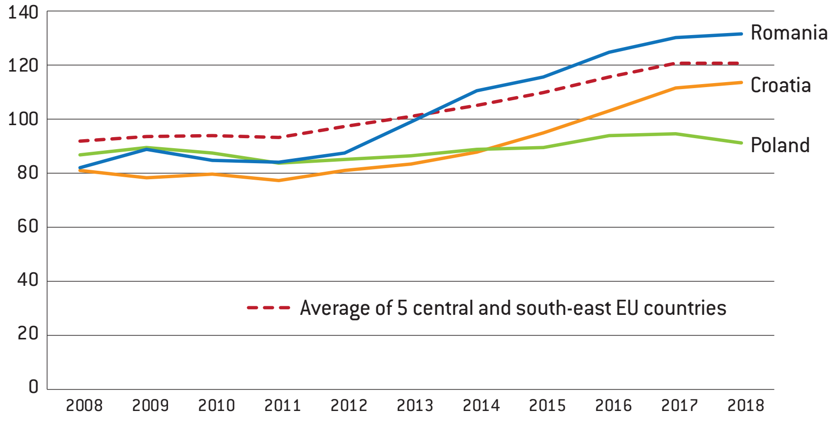
Notes: Table shows all euro-area banks present in at least three central and south-eastern European countries. Green cells = 0-5%. Yellow cells = 5-10%. Pink cells = >10%. Data is missing for Erste North Macedonia and Intesa Czech Republic; market share in these countries might be underestimated as a result. Unicredit Slovakia figures captured under the Czech Republic and decoupled based on World Bank figures. * Corresponds to the combined market share of euro-area banks in each of the host countries, based on geographical location of the ultimate parent bank (as defined by the SNL Financial database).

Table 1b : Share of euro-area banks' subsidiaries in group assets (%), 2017

			Non-euro area						Euro area					Total
Bank	*Home country*	*Resolution strategy*	*BG*	*HR*	*CZ*	*HU*	*PO*	*RO*	*EE*	*LV*	*LT*	*SK*	*SI*	
Banco Santander	ES	MPE	-	-	-	-	2.5	-	-	-	-	-	-	2.5
BNP Paribas	FR	unclear	-	-	-	-	1.5	-	-	-	-	-	-	1.5
Crédit Agricole	FR	SPE	-	-	-	-	0.3	0.0	-	-	-	-	-	0.3
Deutsche Bank	DE	SPE	-	-	-	-	0.6	-	-	-	-	-	-	0.6
ING	NL	SPE	-	-	1.0	-	3.6	-	-	-	-	-	-	4.6
Société Générale	FR	SPE	0.3	-	3.3	-	0.3	0.9	-	-	-	-	0.2	5.0
UniCredit	IT	SPE	1.2	2.0	2.5	1.1	-	1.1	-	-	-	0.6	0.3	8.9
Millenium BCP	PT	unclear	-	-	-	-	23.7	-	-	-	-	-	-	23.7
Commerzbank	DE	unclear	-	-	-	0.2	7.6	-	-	-	-	-	-	7.8
Erste	AT	MPE	-	4.0	24.9	3.5	-	7.2	-	-	-	7.4	-	47.0
Intesa	IT	SPE	-	1.8	-	0.7	-	0.1	-	-	-	1.9	0.3	4.8
KBC	BE	SPE	1.5	-	19.6	3.3	-	-	-	-	-	3.2	-	27.6
Nordea	FI	SPE	-	-	-	-	-	-	14.0	0.8	1.2	-	-	16.0
Raiffeisen	AT	MPE	2.7	3.4	9.9	5.2	-	5.8	-	-	-	9.3	-	**36.3**

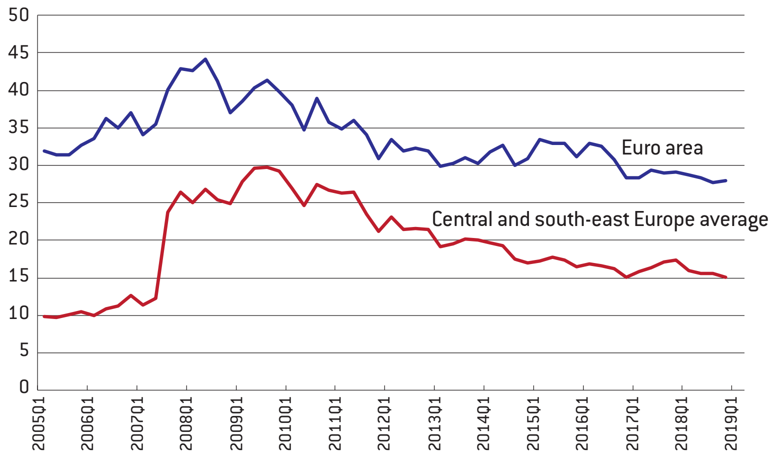
Source for both tables: Bruegel based on SNL Financial, Fontan *et al* (2019) and banks' annual reports and investor presentations. Notes: Data is missing for Intesa Czech Republic; Unicredit Slovakia figures captured under the Czech Republic and decoupled based on World Bank figures.

Figure 3: Deposit-to-loan ratios in central and south-eastern EU countries



Source: IMF Financial Soundness Indicators ('Customer deposits to total (non-interbank) lending'). Notes: data for Hungary is missing. Data complete from 2008. Average of five countries covers Bulgaria, Croatia, the Czech Republic, Poland and Romania.

Figure 4: Loans by euro-area banks by residence of the counter-party (% of GDP)



Source: BIS Locational Banking Statistics (2019Q1). Notes: External position of all euro-area BIS-reporting banks by residence of counter-party. Amounts outstanding/stocks of total cross-border claims on all instruments. Countries included in the average are Bulgaria, Croatia, the Czech Republic, Hungary, Poland and Romania. Averages are weighted according to GDP.

An assessment of whether central and south-eastern European financial markets have become more or less integrated with the rest of the euro area would yield different answers depending on which of the three common empirical measures is used: first, cross-border capital flows of course remain unimpeded by explicit restrictions within the single market (Bush, 2015); second, cross-border holdings of financial securities (in particular in several large local sovereign debt markets) have kept price trends in key asset classes closely aligned; a third measure of discriminatory treatment of local market participants (based on Baele, 2004) yields a more nuanced outcome.

The European financial crisis offered ample evidence of failures in the coordination of crisis-management measures between home and host countries and of resolution strategies focused on individual countries at the expense of the group. This resulted in ring-fencing of capital and liquidity by both home and host countries, which damaged the resilience of banking groups and resulted in additional risks for sovereign finances within the parent banks' home jurisdictions.

Even under the revamped EU banking rules, numerous obstacles still impede the free flow of capital, liquidity and information within cross-border banks in the single market (EBA, 2018). The ECB has argued for some time that the common prudential standards within the banking union justify waiving capital and liquidity requirements that are applied by individual jurisdictions. For instance, even the funding of a subsidiary by its parent within the euro area might still be subject to large exposure limits, just like those applied to unrelated parties. These measures are consistent with EU legislation, such as the Capital Requirements Directive (2013/36/EU), but often originate with government agencies, rather than the supervisor, or are classed as macro-prudential, rather than bank-specific measures (Table 2).

The EU countries in central and south-east Europe appear to be particularly active users of limits (Kudrna and Puntscher Riekman, 2017). In central and south-eastern European countries, more stringent treatment is introduced more quickly, options to demand additional capital buffers are utilised fully, and exemptions on the holding of liquidity within foreign-owned subsidiaries are accepted more rarely than elsewhere in the EU. A common effect has been to segment capital and liquidity within banking groups.

There is a clear risk that the existing segmentation of banking markets that arises from the regulatory treatment of foreign subsidiaries will now be accentuated by the way resolution planning is done and by how the requirements are set for associated bail-in funds.

Table 2: Overview of national options and discretions ('NODs')

Legal basis	NODs can be enshrined in the Capital Directive, rather than the harmonised regulation, and hence give rise to differing national implementation
Responsible body	NODs may be implemented by member states, rather than the competent authority, are outside Single Supervisory Mechanism (SSM) jurisdiction
Time horizon	The envisaged timeline for phasing out NODs differs between countries
Types of measure	Micro-prudential NODs largely concern the quality of bank capital and are under the purview of the single regulator (and hence the SSM regulation), whereas macro-prudential measures relate to the level of capital to counter systemic risk
Scope of measures	Exemptions could be granted across the board or only on an individual basis through waivers and derogations.

Source: European Parliament.

3 Resolution plans with single and multiple points of entry

To understand the emerging tensions between home and host countries in Europe it is important to recap the distinction between the two principal models of resolution: this could be done via a 'single point of entry' (SPE) or through 'multiple points of entry' (MPE), depending on whether one or several resolution schemes address all or separate parts of a failed banking group. These were the two stylised scenarios set out in the original guidance from the Financial Stability Board (FSB, 2013). At the time, this represented an important innovation in cross-border banking policy (Tucker, 2013). With the EU's June 2019 banking package, this treatment of global systemically important banks (G-SIBs) has been replicated in the revised Bank Recovery and Resolution Directive (BRRD2) and the Regulation on the Single Resolution Mechanism.

In the SPE model, a single resolution scheme applies to the entire group under the direction of the home-country authority[6]. Subsidiaries in host countries issue bail-in capital (equity and sub-ordinated bonds) to a parent or holding company. This is loss-absorbing capital (in EU terminology, the minimum requirement for own funds and eligible liabilities or MREL) that is internal to the group and no other investors hold these liabilities[7]. Only the holding company would issue MREL-type sub-ordinated bonds into the market under home-country law, and holding-company MREL is at least as large as the sum of all internal MREL issued to it by all subsidiaries.

Once losses occur within any subsidiary, the parent will need to inject capital to meet host-country regulation for capital coverage, or if necessary, convert internal MREL into equity. Losses are passed up and capital is passed down.

If a failing subsidiary is large enough, its losses might put at risk the entire holding company

However, if the subsidiary is large enough, its losses might put at risk the entire holding company (in EU terms, render it failing or likely to fail). As the holding company enters resolution, the home authority implements its global resolution plan, and there is no need for different national insolvency proceedings. All assets are valued but resolution tools are implemented at the holding-company level only (the resolution entity). Its equity is written off, subordinated debt issued by the holding company may be converted into equity, and other senior bonds might suffer the same fate. This allows the recapitalisation of the subsidiaries.

A key feature of this model is that, at least initially, the ownership structure of the group remains intact. Underlying profitability problems, including in the host countries, can be dealt with based on a group restructuring plan. As subsidiaries issued subordinated debt only to the holding company, only its investors are subject to a bail-in within the resolution scheme. Other host-country liabilities of the subsidiary will remain senior to those of the holding company. A key benefit of SPE is that only one agency – in Europe, most likely the SRB – will be in charge. The solution is also efficient in preserving equity, which can be allocated wherever needed within the group.

However, it is essential that all home and host-country authorities cooperate in this solution. For example, should a loss occur in a single subsidiary and deplete the capital at holding-company level, at first internal bail-in capital (MREL) would be converted and possibly additional capital would be made available to the subsidiary. Should a host supervisor have doubts about the commitment of the parent to this process, it would be faced with a bank that is failing under local law. In anticipation of such an outcome, the host authority would be inclined to ring-fence capital, as would other jurisdictions where the group has a presence. In the absence of trust in a cooperative outcome, the single resolution scheme cannot be relied on and would be rendered unworkable through national ring-fencing strategies.

The polar opposite of this scenario is the model of multiple resolution schemes (MPE) evolving in parallel. Here, the banking group is resolvable within the national boundaries of each of the jurisdictions in which it operates, with minimal need for coordination (resolution groups may also apply to several member states). Clearly this sets a high bar, not just for raising bail-in capital in each jurisdiction, but also for making the bank 'resolvable' in legal and operational terms. Following a resolution, investors in subordinated debt would be converted into a set of distinct national groups of new owners. The group would be essentially broken up along national lines.

As shown by Faia and Weder di Mauro (2016), the SPE scheme in which all host countries cooperate is more efficient than the MPE regime, in terms of sustaining financial integration and containing losses borne by bond holders following a resolution. However, national ring-fencing measures, or even the option to impose such restrictions, will undermine an SPE resolution scheme. In the context of poor home-host cooperation, the still patchy single

6 The scheme could also apply to just a part of the banking group (the so-called 'resolution group').

7 MREL is the sum total of all capital support in resolution (for globally systemic banks the equivalent measure is total loss-absorbing capacity, TLAC). It is typically set a level roughly twice that of minimum capital requirements, so about 24 percent of risk-weighted assets. Where no capital buffers exist, an institution might therefore be asked to raise subordinated debt in an amount similar to its equity base.

resolution schemes might well be inferior to both of the stylised regimes set out here. Of three competing objectives – financial stability, cross-border banking and national crisis-resolution policies – only two can be attained simultaneously (Schoenmaker, 2017).

4 Priorities for three groups of countries

Whether a bank opts for a single resolution scheme or one administered in multiple jurisdictions depends on its business model and to what extent individual units would be separable in a resolution (and this initial choice would then need to be approved by the resolution college). SPE has been the preferred model for groups where wholesale banking dominates and where there are substantial exposures between different parts of group, such as in investment banking. Conversely, the MPE model appeals in particular to retail banks with local deposit funding, which operate as separate businesses, albeit with shared central services and common risk-management standards.

At the time of writing, resolution colleges have not finalised these decisions, which would in any case be revisited regularly (Table 1b lists the banks' early choices as disclosed in investor disclosures). The two leading Spanish banking groups, BBVA and Santander, have opted for MPE, based on the long-standing decentralisation of their Latin American subsidiaries (BBVA, 2014). Austrian groups Erste and Raiffeisen International, each with extensive subsidiary networks in central Europe, similarly opted for this model. However, UniCredit Group, present in nine countries in central and south-east Europe, structures itself around a single point of entry.

Banking groups now need to become 'resolvable' in line with their chosen models. The need to choose between the two models has already resulted in wide-ranging changes to the legal, organisational and financial structures of European banking groups. SPE banking groups have established holding companies that now issue subordinated bonds for the entire group. For groups under an MPE scheme, operational resolvability is clearly a key challenge. Groups have reorganised into regional and functional sub-groups, often with associated holding companies subject to individual SPE resolution schemes. Common services such as IT, treasury or marketing have been separated into entities that would not be affected by a resolution of the group.

In practice, the choice between the two models may not be clear-cut and various hybrid solutions have been designed, for instance through regional holdings, or where a subsidiary in one host country manages bank branches in another.

The SRB has regularly coordinated the resolution colleges. There have been some public remarks pointing to tensions between home and host countries, though by time of writing only one mediation case had been taken to the European Banking Authority (EBA), by the National Bank of Romania in 2018[8].

4.1 Resolution planning within the banking union

In principle, within the banking union there is no longer a distinction between home and host countries. The SSM conducts supervision based on a 'single rulebook,' in the process approving recovery plans for entire groups, and would take a decision that the group is 'failing or likely to fail' based on the consolidated balance sheet. A resolution plan is similarly drafted for groups as a whole, as within the euro area, most banking groups would typically choose the SPE approach with the parent as the single resolution entity. The SRB is required to take a

8 The EBA's decision is however heavily redacted: https://eba.europa.eu/eba-issues-first-binding-mediation-decision-between-the-srb-and-the-nbr.

balanced approach that respects the interests of all countries[9].

In practice, local authorities retain a significant influence because they play a key role in shaping the resolution process. Emergency liquidity assistance (ELA) on which the local subsidiary might need to rely heavily in a pre-crisis situation, remains at the sole discretion of the local government.

In practice, local authorities retain a significant influence in shaping the resolution process; emergency liquidity assistance remains at the sole discretion of the local government

Despite these centralised powers in supervision and resolution, the various national options and discretions set out in section 3 (Table 2) still also allow ring-fencing of intra-group capital transfers within the banking union. In light of this still imperfect integration, the revised BRRD provides for internal MREL to be set at a level equivalent to what it would be if the subsidiary was an independent institution. Oddly, the comparable standard set by the Financial Stability Board for G-SIBs would recommend a range of between 75 and 90 percent of that level. Also, a euro-area host-country authority may still demand a recovery plan for the individual subsidiary, even if such a plan has already been approved for the group as a whole. Paring back such powers remains a challenge even under the banking package that has come into effect in 2019, and might require other safeguards for host countries (Council of the EU, 2019).

The five euro-area countries in central Europe (the Baltic States, Slovakia and Slovenia) have been subject to integrated supervision and resolution planning for several years. Arguably, the options under the revised BRRD return some further powers to local resolution authorities.

More credible standards in supervision through the SSM, and common resolution planning, including access to the Single Resolution Fund, should in principle make the banking union attractive for the remaining non-euro EU countries in the region (Hüttl and Schoenmaker, 2016; Lehmann and Nyberg, 2014). Bulgaria and Croatia are at time of writing in the process of entering a 'close cooperation' with the ECB, and thus will come under the resolution powers of the SRB. Romania might take a similar step in the future. All three countries are hosts to euro-area bank subsidiaries that are systemic within their own markets. The subsidiaries in Romania are also systemic within three euro-area banking groups (Table 1).

4.2 EU countries outside the banking union

Three key host countries with a significant euro-area bank presence will likely remain outside the banking union for the foreseeable future: Hungary, Poland and the Czech Republic. Given their tendency towards more inward-looking industrial and banking policies, tensions with the euro-area institutions could easily emerge.

The EU's post-crisis regulatory framework, as embodied in the CRR/CRD legislation, has in many ways addressed past coordination failures. All EU host countries are members of group-level supervisory colleges, via which they are given access to information and participate in all decisions. Importantly, this includes the approval of each bank's recovery plan (a strategy to pre-empt stress drafted by each bank). Asset sales or additional funding facilities could directly impact subsidiary operations. This coordination between the SSM and non-euro area EU supervisors seems to have worked well, though some tensions have emerged over the supervision of large branches. On the whole, host-country rights have largely been respected[10].

In relation to resolution planning, host-country authorities and the SRB decide on joint strategies in the resolution colleges, which meet less frequently than the supervisory colleges. This process is newer, and has been less transparent than the supervisory college process.

For EU host countries outside the banking union, acceding to SPE schemes led by the SRB will require considerable trust that resolution and restructuring at parent level will leave subsidiary operations intact. Even though no subordinated debt needs to be issued under an SPE

9 Fontan *et al* (2019), and Art. 6 SRMR.

10 Fontan *et al* (2019) informally surveyed EU host country supervisors, and still detected problems in information sharing, including coordination of on-site inspections.

scheme, some subsidiaries are owned to a significant degree by local investors. Poland, for instance, has had a long-standing policy of fostering equity issuance of foreign-bank subsidiaries on the local market.

Host countries will be especially keen to ensure that the losses and recapitalisation needs of local subsidiaries in a single-point-of-entry scheme can be passed with legal certainty to the resolution entity in the euro area. The Financial Stability Board guidance (FSB, 2017) that covers the design of internal bail-in funds of G-SIBs is instructive in this regard:

- Issuance should ideally be direct from the subsidiary to the parent;
- Internal MREL should be governed by host-country law, as this gives the host resolution authority the option to apply its own powers if the home authority (SRB) does not trigger conversion of MREL;
- Home authorities should not subject internal MREL to large exposure limits;
- There should be consistent creditor hierarchies;
- The parent should cover internal MREL exposures fully with its own capital base (rather than discounting the exposure through risk-weights).

A key question for any host country cooperating in SPE schemes will concern the use of the Single Resolution Fund, which is funded by euro-area banks, and the future backstop facility from the European Stability Mechanism, which is funded by euro-area taxpayers. It is easy to foresee tensions if resolution of the entire group would in part be needed because of problems with a substantial subsidiary outside the banking union.

Several banking groups have proposed the alternative strategy of multiple resolution points, or have been encouraged to adopt such schemes in the resolution colleges. Pressure by host countries to design local resolution schemes could be circumvented by switching to a structure of branches which would all be subject to a single home-country resolution scheme, and would benefit from potential support from the Single Resolution Fund. These branches would be guaranteed in, and operate out of, the euro-area home jurisdiction (as notably done by Nordea, which moved the group head office from Sweden to Finland).

Accommodating resolution plans based on multiple points of entry, including a local scheme, confronts two further complications.

The first is the lack of an investor base for locally-issued subordinated debt. Several central and south-eastern European countries have already argued that their domestic bond markets are too shallow to support issuance of bail-in capital that supports local resolution schemes. Figures from the ECB's securities database (Table 3) make it clear that some capital markets, such those in as Croatia or Bulgaria, are indeed too small to allow sizable issuance. Local banks are primarily funded through deposits, and bank bond issuance is barely developed (S&P, 2017).

Others, such as the Czech Republic, Slovakia and Poland, seem to have sufficient local capitalisation to sustain issuance, even though local banks might not be well prepared to launch issuance programmes and engage investors. This points to the general problem of a dearth of a local institutional investors, and uncertainty about how a creditor bail-in would proceed.

Where the domestic market is a constraint, international financial institutions, such as the European Bank for Reconstruction and Development (EBRD), have already begun to invest in the MREL of local banks. In this way they assume part of the risk of local bank failures, and become exposed to a bail-in under a local resolution regime (somewhat undermining the policy objective of shifting this risk to private investors). Supranational investors can help develop host country regulations for creditor bail-in, build investor bases and provide a reliable demand for an as-yet novel asset class.

There is an ongoing debate about whether parent banks should help overcome this constraint by funding the bail-in capital of their subsidiaries. Home countries argue that a host-country resolution scheme supported by internal MREL would expose the parent to contagion, which the home country has only limited powers to contain. This overlooks the fact that a host-country supervisor outside the euro area always has the ultimate power to declare a subsidiary as failing, and in doing so would trigger conversion of bail-in funds (whether or not these are internal).

Table 3: Local bond market capitalisation (% of GDP) by sector of the issuer

	Euro area	Bulgaria	Croatia	Czech Rep.	Hungary	Poland	Romania
Total outstanding stock	105.5	4.2	19.3	75.3	55.7	40.7	16.1
thereof							
Govt. bonds	68.8	3.9	18.3	26.1	51.6	31.7	16
Corporate bonds	9.6	0.3	0.9	2.3	0.5	3.9	0
Bank bonds	27.1	0	0.1	46.9	3.6	5.1	0.2

Source: ECB SEC. Notes: bonds defined as non-share securities issued by general government (government bonds), non-financial corporations ESA 2010 classification (corporate bonds), and MFIs (bank bonds). Includes bonds issued in domestic currency only.

The second concern about MPE resolution plans is that the integrated structure of banking groups in the region might not be amenable to local resolution schemes. Unlike the group-wide resolution plan in the SPE model, the resolution plan conceived by the host country in the MPE scheme in principle requires the operational and financial separation of two or more resolution entities (eg made up of a subsidiary and the entities under it) within the overall banking group. Under the BRRD, it is within the host country's powers to direct the resolution entity (subsidiary) to address the so-called 'barriers to resolvability'. This might include fairly intrusive measures, such as organisational or structural changes, or restrictions on certain business lines (World Bank, 2016).

The growing reliance on host-country funding, as depicted in Figure 3, suggests that central and south-eastern European subsidiaries would be well-prepared for separation from the parent, should the host authority require independent treasury functions. Other functions shared within the group could be relatively easily replicated locally – for example IT or marketing – or can at least be outsourced, even though such an operational decentralisation of course entails further costs.

This financial and organisational separation of subsidiaries would undermine the very business case of the euro-area network banks that operate in the CEE region. Nevertheless, several banking groups have already adopted such a more decentralised structure, and indeed seem inclined to adopt an MPE strategy for their subsidiaries.

4.3 Banking networks in the candidate countries and EU neighbourhood

The presence of euro-area banks in the countries in the immediate EU neighbourhood is in many cases as deep as their presence within the EU states of central Europe. Immediate neighbourhood countries can be divided into two groups: the four candidate countries (Albania, Montenegro, North Macedonia and Serbia), and countries without an immediate membership prospect. All would be considered 'third countries' by home-country supervisors, even though the alignment with EU financial regulation is increasingly close. Candidate countries in particular have adopted laws on resolution very similar to the BRRD[11].

A potential risk is that in the absence of good coordination and information sharing, host countries might be tempted into local resolution schemes and ring-fencing solutions. In practice, the presence of euro-area banks in the western Balkan countries is sufficiently deep

11 The three countries with EU Association Agreements (Ukraine, Georgia and Moldova) are also obliged to approximate their financial regulations to those of the EU, including for newly adopted legislation.

so that host countries have allowed the SRB take a lead in designing group-wide resolution schemes[12]. All countries have secured a determination from the European Commission that their confidentiality standards are equivalent to those in the EU and the SRB has signed cooperation agreements with its counterparts in Serbia and Albania. Nevertheless, much could be done to improve cooperation, in particular by involving host authorities in a wider range of supervisory processes, in particular in resolution colleges.

5 Policies that foster cooperation

Amidst solid economic growth rates, return on equity and capital coverage in the banking sectors of the central and south-eastern European EU members remain very strong. Unlike in the immediate aftermath of the crisis, there is little perception of financial vulnerability, and a number of countries are seeking to strengthen domestic ownership of local banking sectors. The benefits that euro-area banks brought to the region remain valuable, in particular in the form of risk management skills and funding capacity in the context of shallow local debt markets.

Despite the much more uniform EU regulatory framework and the strengthened balance sheets of euro-area banks, the memory of the financial crisis that posed major fiscal risks to host governments is still alive. EU countries continue to use various instruments that impede the sharing of capital and liquidity within bank groups.

Even within the banking union, capital and liquidity within banking groups is not fully fungible. Ring-fencing by home and host countries, and the policy of pre-positioning bail-in capital within the subsidiaries of banking groups subject to a single SRB-led resolution scheme, are the consequence of inadequate risk sharing within the currency union. The revised BRRD did little to overcome this fragmentation, and possibly accentuates it.

The SRB's resolution planning, and its cooperation with authorities in the region, should aim to preserve the benefits of financial integration. The SRB taking the lead in a single resolution strategy is efficient in terms of preserving shared liquidity and capital, and the common functions of the banking group, though is demanding in terms of home-host cooperation:

- Within the banking union there needs to be a clearer process to phase out ring-fencing of capital and liquidity as some limited risk-sharing takes hold. Barriers to intra-group capital mobility have no justification in the ultimate steady state of fully-integrated national banking markets. During the transition to a fully-fledged banking union, host countries might require certain safeguards. Setting requirements for bail-in capital funded by the parent could offer such reassurance. In a steady-state banking union with full risk sharing, such pre-positioning of bail-in capital would be no longer necessary. National insolvency regimes for banks should also be harmonised with this long-term aim in mind.
- Close cooperation between the SRB and host countries outside the banking union will be essential. This should include early and full access to bank recovery plans and draft resolution plans in the colleges. SRB-led resolution plans for entire groups would need to reassure host countries that bail-in capital can be converted once deemed necessary by the local supervisor. This would entail use of the single resolution fund and the ESM backstop – in other words euro-area fiscal resources for banking sector risks outside the banking union.

At the same time, the SRB will need to be prepared that large EU host countries outside the

12 A memorandum of understanding was signed by the European Banking Authority and six countries in south-eastern Europe in 2015 putting in place a process for such convergence.

banking union will implement independent resolution planning.

- Local resolution plans in large host countries will need to be reconciled with the SRB-led schemes which might only cover part of a banking group but presume capital mobility across the entire group. The colleges where resolution plans are discussed will need to become more encompassing and transparent, also to pre-empt *ad-hoc* host-country ring-fencing measures.
- For their part, banks need to become more transparent about how they are reorganising to become 'resolvable' along national or regional lines, as defined by their chosen resolution strategies. The SRB's draft resolvability assessment standards published in October 2019 will guide banks better in this area[13]. Banks could offer more credible scenarios for the potential financial support between different parts of the group. So far, banks seem to overestimate their capacities to strengthen capital and liquidity in a crisis (ECB, 2018). The so-called group financial support agreements that would allow the up-streaming of capital and liquidity from the subsidiaries ahead of a crisis could be further developed[14].
- Finally, there is a need to make local laws on creditor hierarchies and bail-in compliant with the BRRD. Bail-in capital issued between parts of a single group is in the nature of a 'private placement' though may ultimately be traded in public markets. Locally issued subordinated debt could be developed with the help of supranational investors. Independent resolution schemes that concern only local subsidiaries ultimately need to be backed up by a local investor class that shelters host-country taxpayers from the risks of bank failure.

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13 Available at https://srb.europa.eu/en/node/866.

14 These are envisaged under Art. 19 BRRD.

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