BANKING SUPERVISION AND RESOLUTION IN THE EU

EFFECTS ON SMALL HOST COUNTRIES IN CENTRAL, EASTERN AND SOUTH EASTERN EUROPE

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Background

A common feature of many FinSAC client countries' banking system is the significant presence of subsidiaries of multinational banks, generally with parent banks from the EU. Most of those subsidiaries are of systemic importance in the host country, but in many cases these foreign operations are not material for the parent bank and thus for the home country supervisory and resolution authority. These "small hosts" face a unique set of policy and implementation challenges, which do not feature prominently on the international and EU agenda. Moreover, EU directives and regulations are not designed with these smaller host countries' banking systems in mind, especially with non-EU countries where the hosts rights don't apply, and their implementation is often challenging. To address these challenges, FinSAC provides bilateral independent and tailored expertise, technical assistance and advice.

For example, FinSAC has assisted bank supervisors and resolution authorities in the CESEE with the design of new supervisory and resolution approaches based on the EU legal and regulatory frameworks. In the bank supervision area, FinSAC's technical assistance has included business model assessment, internal governance and risk management, credit risk, operational risk, market risk, interest rate risk in the banking book, capital, and liquidity, as well as the operating model of the new supervisory approach. Other bank supervision projects included the assessment of the prudential implications of IFRS 9 and the implementation of the Supervisory Review and Evaluation Process (SREP).

For bank resolution, FinSAC has worked closely with several authorities to help them create and operationalize a resolution framework and advance the assessment of banks' recovery plans. FinSAC has assisted with drafting by-laws on valuation, recovery, and resolution planning – including the adaptation of EBA bank information templates to the local framework – and helped clients prepare for the assessment of the first recovery plans. FinSAC has also offered technical advice on internal information and cooperation rules and provided example resolution fund calculations. A resolution plan manual has also been developed by FinSAC, including analysis of good practice examples for resolution authorities' internal decision making, recovery and resolution planning, and the taking of resolution decisions.

Many of our client countries are EU candidates, and hence are in the process of introducing and implementing complex EU regulations. Notwithstanding this, candidate countries are still considered and treated as third countries which means they are not part of the EU rule making process. Hence, our clients often lack insight in the practical application of the EU legal and regulatory framework and face difficulty in finding counterparts to share their experience candidly. FinSAC is well-aware of the necessity for our client countries to fully understand the EU legal and regulatory framework.

In this publication, we have carefully analyzed the EU legal and regulatory framework for bank supervision, recovery and resolution from the perspective our client-countries. Our analysis distinguishes between small hosts (i) inside the Eurozone, (ii) inside the EU but outside the Eurozone, and (iii) outside the EU. The latter category consists of non- EU -candidate countries and third countries. The implications for cross-border supervision and resolution cooperation are distinct in each of these cases. We hope this will be the basis for further discussions between authorities within and outside the region.

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Acronyms

BRRD	BANK RECOVERY AND RESOLUTION DIRECTIVE
CAPTAC-DR	IMF REGIONAL TECHNICAL ASSISTANCE CENTER FOR CENTRAL AMERICA, PANAMA AND THE DOMINICAN REPUBLIC
CCSBSO	CENTRAL AMERICAN COUNCIL OF SUPERINTENDENTS OF BANKS, INSURANCE AND OTHER FINANCIAL INSTITUTIONS
CET	COMMON EQUITY TIER
CESEE	CENTRAL AND EASTERN EUROPE
CMGS	CRISIS MANAGEMENT GROUPS
CRD	CAPITAL REQUIREMENTS DIRECTIVES
DGS	DEPOSIT GUARANTEE SCHEME
DR	DELEGATED REGULATION
EBA	EUROPEAN BANKING AUTHORITY
EBRD	EUROPEAN BANK FOR RECONSTRUCTION AND DEVELOPMENT
EC	EUROPEAN COMMISSION
ECA	WORLD BANK EUROPE AND CENTRAL ASIA REGION
ECB	EUROPEAN CENTRAL BANK
EDIS	EUROPEAN DEPOSIT INSURANCE SCHEME
ELA	EMERGENCY LIQUIDITY ASSISTANCE
EU	EUROPEAN UNION
FOLTF	FAILING OR LIKELY TO FAIL
FINSAC	FINANCIAL SECTOR ADVISORY CENTER
FSB	FINANCIAL STABILITY BOARD
GFSA	GROUP FINANCIAL SUPPORT AGREEMENT
GLRA	GROUP LEVEL RESOLUTION AUTHORITY
G-SIBS	GLOBAL SYSTEMICALLY IMPORTANT BANKS
HQLA	HIGH QUALITY LIQUIDITY ASSETS
HVB	HYPOVEREINSBANK
ICAAP	INTERNAL CAPITAL ADEQUACY ASSESSMENT
ILAAP	INTERNAL LIQUIDITY ADEQUACY ASSESSMENT
IMF	INTERNATIONAL MONETARY FUND
IRT	INTERNAL RESOLUTION TEAM
JST	JOINT SUPERVISORY TEAM
LAA	LOSS ABSORPTION AMOUNT
LCR	LIQUIDITY COVERAGE RATIO
M&A	MERGERS AND ACQUISITIONS
MLE	MATERIAL LEGAL ENTITY
MoU	MEMORANDUM OF UNDERSTANDING
MPE / MPOE	MULTIPLE POINT OF ENTRY
MREL	MINIMUM REQUIREMENT FOR OWN FUNDS AND ELIGIBLE LIABILITIES
NPL	NON-PERFORMING LOANS
NRA	NATIONAL RESOLUTION AUTHORITY
OeNB	OESTERREICHISCHE NATIONALBANK
PONV	THE POINT OF NON-VIABILITY
RCA	RECAPITALIZATION AMOUNT
RWA	RISK-WEIGHTED ASSETS
SEP	SUPERVISOR EXAMINATION PROCESS
SI	SIGNIFICANT INSTITUTION
SPE	SINGLE POINT OF ENTRY
SREP	SUPERVISORY REVIEW AND EVALUATION PROCESS
SRB	SINGLE RESOLUTION BOARD
SRF	SINGLE RESOLUTION FUND
SRM	SINGLE RESOLUTION MECHANISM
SRMR	SINGLE RESOLUTION MECHANISM REGULATION
SSM	SINGLE SUPERVISORY MECHANISM
TLAC	TOTAL LOSS ABSORBING CAPACITY
US	UNITED STATES
WDCC	WRITE-DOWN OR CONVERSION OF CAPITAL

1. Introduction

The objective of this paper is to explain and analyze the implications of recent supervisory and resolution reforms in the European Union (EU) for small host countries in Central, Eastern, and South Eastern Europe (CESEE) whose banking systems are dominated by Western European banks. By "small host countries" we understand those in which subsidiaries of multinational parent banks are of systemic importance, while the foreign operation is not material for the parent bank and thus for the home country authority. These "small hosts" face a unique set of challenges, that do not feature much on the international agenda.

Small hosts are very common in the CESEE region where the banking systems are dominated by subsidiaries of multinational banks, many with parent banks from the EU. The dominance of foreign banks in the region has often been the result of banking crises and/or privatization waves and has, in most cases, helped form market-based local banking systems and in turn contributed to these economies' overall development and rapid growth. However, foreign banks were also part of a credit boom in the early to mid-2000s, often accompanied by housing price booms, increasing reliance on parent and wholesale funding, and worsening net foreign asset positions. More recently, the post-crisis retrenchment of European parent banks has been blamed for falling lending and rising financing costs in the region and led to the Vienna Initiative by the European Bank for Reconstruction and Development (EBRD), World Bank, International Monetary Fund (IMF) and European Investment Bank to prevent a large-scale and uncoordinated withdrawal of cross-border bank groups from the region.

The global financial crisis has led to significant reforms in cross-border supervisory cooperation. The failure of big international financial institutions (e.g., Lehman Brothers) and cross-border banks (e.g., Fortis, Dexia, and the Icelandic banks), and their rather chaotic resolution played a prominent role in the unfolding of the crisis. The resolution of these institutions had to be undertaken on a national level, given the lack of tools to coordinate resolution across borders. Consequently, recognition grew that the main tools of supervisory cooperation available during the financial crisis, such as supervisory colleges, were not sufficient to deal with (distressed) large and systemically important cross-border financial institutions. Since then, there have been multiple global initiatives by international standard setters such as the Financial Stability Board and the Basel Committee to strengthen cross-border cooperation during normal and crisis times. Still, these initiatives continue to rely on voluntary cooperation among home and host supervisors.

This is different from the EU where binding cross border cooperation and consensus based joint decision making among supervisors and resolution authorities exist. Within the Eurozone, the most important initiative has undoubtedly been the (incomplete)[1] construction of the European banking union. The Single Supervisory Mechanism (SSM) has been complemented by a largely centralized Single Resolution Mechanism (SRM), even though it is still reliant on national execution and provides European Commission and European Council veto rights.

Our analysis distinguishes between small hosts (i) inside the Eurozone, (ii) inside the EU but outside the Eurozone, and (iii) outside the EU. The latter category consists of EU-candidate countries and third countries. The implications for cross-border supervision and resolution cooperation are distinct in each of these cases, with increasing asymmetries between home and host countries.

The next section gives a short overview of trends in cross-border ownership across the World Bank Europe and Central Asia (ECA) region with particular focus on CESEE countries. Section 3 discusses the regulatory and supervisory challenges arising from cross-border banking. Section 4 describes recent changes in bank regulation and supervision within the EU. Section 5 discusses cross-border cooperation on supervision and resolution from the perspective of small hosts. The final section concludes with recommendations.

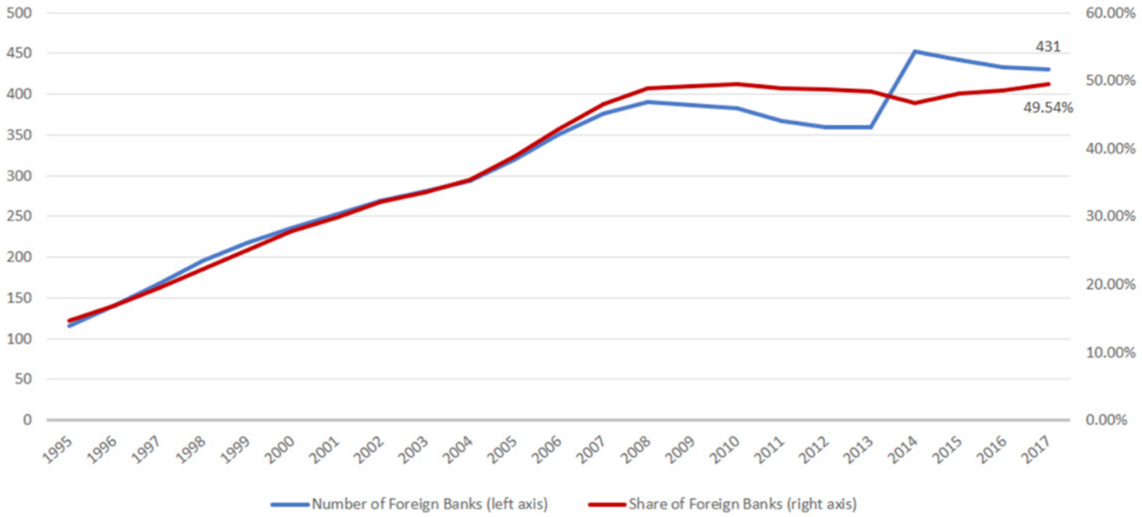
[1] The funding mechanisms, including a European Deposit Insurance Scheme (EDIS) as proposed by the European Commission and a backstop mechanism, await political approval and implementation.

2. Trends in cross border banking in the region

The late 1990s and early 2000s saw a surge in foreign banks and their share in local banking systems in the transition economies of selected ECA countries (Figure 1 and Figure 2).[2] During this period, the region transformed from having the lowest share of foreign banks to having the highest share. Some smaller countries like Croatia have seen their foreign bank share reach 100%. In general, it is the smaller countries of the region that have higher shares of foreign banks. While a few regional banks have expanded across other countries of the region, most foreign banks are from Western Europe.

The transformation of the banking system, from a state-owned mono-bank system towards a privately-owned market-based financial system was key to achieving macroeconomic stability in the late 1990s. Successful transformation – mostly into a foreign-bank dominated system – served as disciplining tool to break the links between banks and incumbent, formerly state-owned enterprises and thus the cycle of non-performing loans, bank recapitalization and inflation. At the same time the banking system supported sectors of the economy that were hitherto de facto un(der)served (e.g. SMEs, households), thereby promoting economic convergence. The entry of foreign banks also helped to raise the bar with respect to risk management practices as well as bank and corporate governance and the break with the past. Indeed, the countries that finalized the ownership transformation process the fastest were also the first ones to emerge from the systemic banking crises of the 1990s.

Figure 1: The number and the average share of foreign banks in ECA over time[3]



Sources: Claessens and van Horen (2015) for data until 2013. For data 2014-2017 websites of central banks and other publicly available sources.

While in EU member states foreign bank penetration has happened using both branches and subsidiaries, non-EU countries have mainly licensed foreign banks as subsidiaries. However, there have also been significant differences across countries in the region.

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[2] We define "foreign bank" as a banking institution with at least 50% ownership stake held by a non-domestic parent bank. Most foreign banks in the region are fully-owned by their parent banks. Foreign banks can enter a country through establishing subsidiaries or branches. Subsidiaries are incorporated in the host country and regulated and supervised by the host country supervisors. If the parent bank exercises control over the subsidiaries, their balance sheet and income statements are consolidated into the parent bank's financial statements. A branch, on the other hand, is part of the parent bank, operationally, legally and financially. A branch is typically regulated and supervised by the home country supervisor and is subject to home country deposit insurance (though the host country can top-up the deposit insurance).

[3] Figure 1 includes all countries from Table 1 except Kosovo due to the lack of comparable data.

Figure 2: Share of domestic and foreign-owned banks in the region over time[4]

Sources: Claessens and van Horen (2015) for data until 2013. For data 2014-2017 websites of central banks and other publicly available sources.

In the subsequent analysis, we differentiate between EU and non-EU countries. Within the group of EU countries, only some have adopted the euro as currency. Within the non-Euro countries, some (most prominently Bulgaria) have a currency board arrangement that effectively ties the local currency to the euro.[5] Further, among the non-EU member countries, we differentiate between EU candidate and non-candidate countries. Table 1 provides a list of countries that we consider in this policy paper and the respective classification. In addition to the above classification, we also denote FinSAC client countries.

Table 1: Country classification

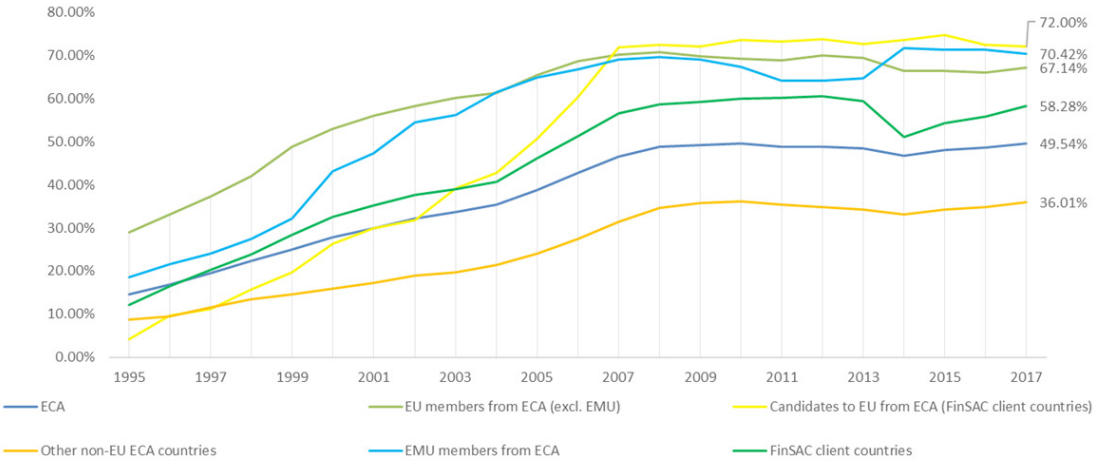
	Eurozone	Non-euro EU members	Non-EU members		FinSAC clients
			Candidate countries	Non-candidate countries	
ALBANIA			✘		✘
ARMENIA				✘	✘
AZERBAIJAN				✘	✘
BELARUS				✘	✘
BOSNIA AND HERZEGOVINA				✘	✘
BULGARIA		✘			✘
CROATIA		✘			✘
CZECH REPUBLIC		✘			
ESTONIA	✘				
GEORGIA				✘	✘
HUNGARY		✘			
KAZAKHSTAN				✘	
KOSOVO				✘	
KYRGYZSTAN				✘	
LATVIA	✘				
LITHUANIA	✘				
NORTH MACEDONIA			✘		✘
MOLDOVA				✘	✘
MONTENEGRO			✘		✘
POLAND		✘			✘
ROMANIA		✘			✘
RUSSIA				✘	
SERBIA			✘		✘
SLOVAKIA	✘				
TURKEY			✘		
UKRAINE				✘	✘
UZBEKISTAN				✘	✘

[4] Figure 2 includes all countries from Table 1 except Kosovo due to the lack of comparable data.

[5] Two non-EU countries (Montenegro and Kosovo) use the Euro as currency despite not being Eurozone countries, which imposes specific challenges for bank supervision. Both countries euroized unilaterally, i.e. bypassing the usual convergence criteria and against the recommendations of the European institutions.

Figure 3 shows the highest foreign bank share for ECA countries are in EU candidate countries (all are also FinSAC client countries), closely followed by Eurozone members of this region, while the third group with very significant shares of foreign banks are EU member countries that are outside the Eurozone.

Figure 3: Foreign bank penetration across different country groups

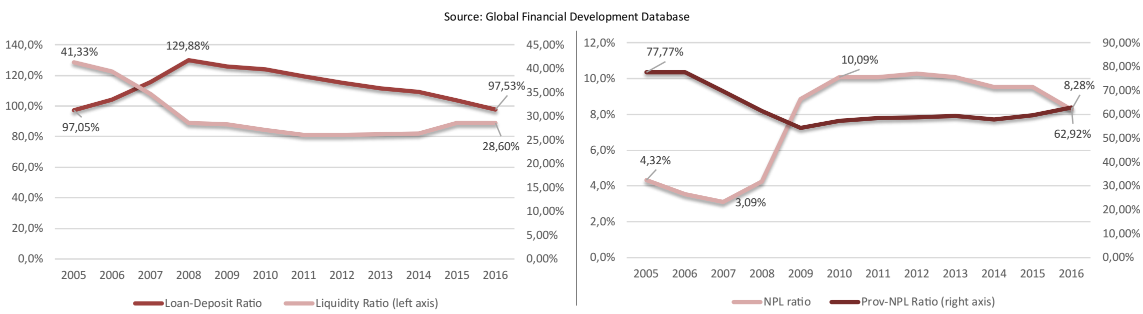


Sources: Claessens and van Horen (2015) for data until 2013. For data 2014-2017 websites of central banks and other publicly available sources.

In the run-up to the crisis, following their parent's strategy, foreign subsidiaries relied increasingly on funding from their parent bank and wholesale markets and reached loan-to-deposit ratios of almost 130%. In the fall of 2008, there was increasing concern, both among policy makers and banks themselves, that there would be a stampede towards the exit in the CESEE region, which might have led to a meltdown of the financial systems of these countries and balance of payment crises. More specifically, there were discussions that some of the large European institutions had to shed subsidiaries in CESEE as a condition for receiving state aid. Starting in late 2008, the IMF, EBRD, EU Commission and others therefore initiated a series of meetings in Vienna with banks, home and host supervisors to prevent this from happening. Many banks made specific roll-over and recapitalization commitments.

Since the crisis loan-deposit ratios have decreased substantially, approaching 100% (Figure 4). At the same time, the liquidity ratio declined until 2008 and has stayed constant at an average of around 25% since then. The non-performing loans (NPL) ratio increased rapidly until 2010 (reaching 10%). It has been on a downward path since then, although it remains high in many countries (right-hand side panel), while the NPL coverage ratio has been stable at an average of around 60%. However, the crisis-induced jump in NPLs and the reduction in funding by parent banks have increased the risk of many banking systems in the region getting stuck in a bad equilibrium of lending reduction and poor real sector performance.

Figure 4: Bank stability in the region over time



Rather than gauging the importance of foreign banks from a country perspective, another way to look at the small host issues is to analyze the simultaneous presence of mainly Western banking groups across many countries throughout the region. In Table 2, we show the share of several international banks across countries in the region (as of 2017).

Table 2: Market share - As a percentage of bank's assets in total banking sector assets

	ALBANIA	BELARUS	BOSNIA	BULGARIA	CROATIA	CZECH REPUBLIC	HUNGARY	KAZAKHSTAN	MACEDONIA	MOLDOVA	MONTENEGRO	ROMANIA	RUSSIA	SERBIA	SLOVAKIA	TURKEY	UKRAINE
UNICREDIT**	✗	✗	24.0%	19.5%	25.6%	9.4%	7.5%	✗	✗	✗	✗	8.8%	1.4%	10.7%	7.3%	16.4%	✗
RAIFFEISEN	17.0%	4.7%	15.8%	7.2%	7.9%	4.8%	6.0%	✗	✗	✗	✗	8.4%	1.0%	7.8%	16.4%	✗	✗
ERSTE	✗	✗	4.8%	✗	14.3%	18.0%	6.1%	✗	4.1%	✗	11.7%	15.8%	✗	4.4%	21.8%	✗	✗
INTESA	11.0%	✗	6.9%	✗	19.0%	4.5%	4.6%	✗	✗	5.8%	✗	✗	✗	16.7%	19.3%	✗	0.4%
SBERBANK	✗	8.2%	8.1%	✗	2.2%	1.2%	1.0%	6.5%	✗	✗	✗	✗	27.3%	3.2%	✗	✗	3.4%
SOCIETE GENERALE*	5.8%	✗	✗	6.6%	✗	13.5%	✗	✗	7.6%	12.1%	11.5%	12.5%	1.4%	7.9%	✗	✗	✗
OTP***	✗	✗	✗	12.4%	11.6%	✗	21.2%	✗	✗	✗	16.0%	1.6%	0.1%	5.5%	1.9%	✗	2.2%

<5%	green
5-10%	yellow
>10%	red

Sources: Raiffeisen CEE Banking Report 2018 and Orbis database
Note: During 2018 Raiffeisen sold its subsidiaries in Poland and Ukraine, and Sberbank sold Denizbank in Turkey
** Societe Generale = Rosbank, Rusfinance and Deltacredit*
*** Unicredit = Q2 2017*
**** OTP = Data for 2016*

Following the global financial crisis, the presence of foreign banks in the region has changed, in some cases significantly. The retrenchment of Greek banks and some Austrian banking groups[6] from several Balkan countries mainly responded to liquidity and solvency issues in their home country. In addition, many banks such as Commerzbank (2012) and Unicredit (2016) sold their operations in crisis-hit countries like Ukraine. In other cases, issues related to the banks' business models and solvency prompted strategic revisions of the banking group, resulting in the divestment of some of their foreign operations.[7]

The expansion of non-Western banking groups in CESEE has run in parallel to the Western European banks' retrenchment.[8] Nevertheless, Western European banks continue to dominate in most countries of the region. For example, Unicredit has very high market shares in Croatia, Bosnia, and Bulgaria, while Raiffeisen Bank is also very relevant in Albania, Bulgaria, Kosovo, and Slovak Republic, and Intesa San Paolo in Croatia, Albania, Serbia, and Slovakia.

Small hosts face the asymmetry between the systemic importance of the subsidiary in the host country and the irrelevance of the host country operation for the overall operation of the parent bank and thus the home supervisor. Table 3 shows for five of the Western European banks present in the region their market share in the different host countries and the share of the respective subsidiary in the group's total assets. The smaller the host country, the more pronounced the asymmetry becomes.

[6] Most of the cross-border bank subsidiaries of the resolved Austrian bank Hypo Alpe Adria (Slovenia, Bosnia-Herzegovina, Serbia, Croatia, and Montenegro) were acquired by Advent (80%) and EBRD (20%) in December 2014 and renamed as Addiko. Another relevant case was the sale of Volksbank International AG (VBI) cross-border subsidiaries to Sberbank in September 2011.

[7] See the case of Raiffeisen Bank in 2015-2016 and its decision to divest its operations in Slovenia and Poland, or the case of Société Générale with the selling of its Croatian, Albanian, Serbian, and Bulgarian operations.

[8] See for example, the cases of OTP, Sberbank or, to a lesser extent, certain Turkish banks

Table 3: Market share in host country and share of assets in group's total assets in 2017

1. Raiffeisen Bank

	Share of assets in group's total assets in 2017	Market share in 2017
Albania	1.39%	17.00%
Belarus	1.06%	4.70%
Bosnia and Herzegovina	1.52%	15.80%
Bulgaria	2.47%	7.20%
Croatia	3.20%	7.90%
Czech Republic	11.98%	4.80%
Hungary	4.99%	6.00%
Romania	5.59%	8.40%
Russia	9.03%	1.00%
Serbia	1.62%	7.80%
Slovakia	9.08%	16.40%

2. Societe Generale

	Share of assets in group's total assets in 2017	Market share in 2017
Albania	0.06%	5.80%
Bulgaria	0.34%	6.60%
Czech Republic	3.70%	13.50%
Macedonia	0.04%	7.60%
Moldova	0.04%	12.10%
Montenegro	0.04%	11.50%
Romania	1.11%	12.50%
Russia	1.42%	1.40%
Serbia	0.23%	7.90%

3. UniCredit Bank

	Share of assets in group's total assets in 2017	Market share in 2017
Bosnia and Herzegovina	0.41%	24.00%
Bulgaria	1.24%	19.50%
Croatia	2.02%	25.60%
Czech Republic	3.15%	9.40%
Hungary**	0.99%	7.90%
Romania	1.11%	8.80%
Russia	2.05%	1.40%
Serbia	0.37%	10.70%
Slovakia*		7.30%
Turkey	6.99%	16.40%

4. Erste Bank

	Share of assets in group's total assets in 2017	Market share in 2017
Bosnia and Herzegovina	0.31%	4.80%
Croatia	4.05%	14.30%
Czech Republic	23.86%	18.00%
Hungary	3.28%	6.10%
Macedonia	0.14%	4.10%
Montenegro	0.22%	11.70%
Romania	6.98%	15.80%
Serbia	0.65%	4.40%
Slovakia	7.41%	21.80%

5. Banca Intesa Sanpaolo

	Share of assets in group's total assets in 2017	Market share in 2017
Albania	0.14%	11.00%
Bosnia and Herzegovina	0.12%	6.90%
Croatia	1.32%	19.00%
Czech Republic	1.57%	4.50%
Hungary	0.68%	4.60%
Moldova	0.03%	5.80%
Serbia	0.61%	16.70%
Slovakia	0.30%	19.30%
Ukraine	0.02%	0.40%

Market share		Share of assets	
<5%	green	<5%	red
5-10%	yellow	5-10%	yellow
>10%	red	>10%	green

Sources: Raiffeisen CEE Banking Report 2018 and Orbis database
** Unicredit bank in Czech Republic covers Slovak market*
*** Data for 2016*

Box 1: Greek banks: parent companies in crisis

Greek banks: parent companies in crisis

Following the introduction of the Euro, many Greek banks expanded across countries using their high profitability and access to wholesale funding. As Greek debt sustainability concerns started to rise, host supervisors in the region grappled with two main problems.

First, a weak parent company could transmit its problems to its local subsidiaries across the region. This contagion may be triggered by intra-group exposures, especially those that involve the upstream of host country deposits to the parent entity. The reaction by many host authorities across the region involved ring-fencing these subsidiaries, for example by imposing higher capital requirements, restricting upstream intra-group exposures, and requiring specific profit retention policies. These measures ensured that the local subsidiaries remained relatively isolated from the liquidity and solvency crisis of their parents.

Second, the Greek banks were forced to divest non-core assets to free up capital to absorb losses in their Greek home market. In particular:

- **National Bank of Greece** sold its operations in Turkey (Finansbank) in 2016, Bulgaria (UBB) and Serbia (Vojvodjanska Banka) in 2017, and in Albania (Banka NBG Albania) in 2018. NBG still retains its subsidiaries in North Macedonia and Romania.

- **Piraeus Bank** divested in 2017 its operations in Romania (Piraeus Bank Romania) and Serbia (Piraeus Bank Beograd). It still owns subsidiaries in Albania (Tirana Bank), Bulgaria (Piraeus Bank Bulgaria) and Ukraine (JSC Piraeus Bank ICB).

- **Eurobank Ergasias** sold its Ukrainian operation (Public JSC Universal Bank) in 2016 and its Romanian subsidiary (BancPost Romania) in 2017, while keeping a relevant position in Serbia and Bulgaria.

- **Alpha Bank** disposed of its Macedonian (Alpha Bank Skopje) and Bulgarian (Alpha Bank Bulgaria) operations in 2016, and of its Serbian subsidiary (Alpha Bank Srbija) in 2017. Alpha Bank still owns subsidiaries in Romania and Albania.

3. Supervision and resolution in cross-border banking problem analysis

This section explains the need for cooperation and coordination between home and host supervisors, especially in (the preparation of) bank resolution, but also asymmetries in information and interests, which diverge even further during crisis situations. Discussing these issues will provide the analytical fundament for the following discussion on regulatory reforms within the European Union and its implications for relationships between home and small host supervisors in CESEE.

3.1. Cross-border externalities associated with a bank failure

One of the main rationales for developing financial safety nets—consisting of regulation, supervision, lender of last resort facilities, deposit insurance, and bank resolution frameworks—is that bank failures and systemic crises can create sizeable negative externalities, which can make them very costly for the real economy.[9] Traditionally, financial safety nets are national. In a world with mostly domestic banking systems and limited cross-border bank flows—so that the externalities of bank failure are limited to domestic agents—there is little, if any, need for cross-border cooperation. However, in a world where banks are involved in cross-border activities, distortions arise from a national supervisory process, as we spell out in the following.

Ownership linkages: First, cross-border externalities arise from cross-border activities of specific financial institutions. For example, a bank failure may impose costs on borrowers abroad by leading to lower credit availability to foreign firms or may cause foreign depositors to lose access to their savings. These externalities are not always considered by domestic supervisors who are focused on domestic stakeholders and domestic financial stability as they are accountable to domestic governments and taxpayers. To avoid these distortions, the geographic perimeter of the responsible supervisor should match the geographic footprint of the bank. However, an alignment of supervisory mandates and banks' footprints is hard to implement in practical terms, given the size of banks' geographic footprints and their variability over time as well as legal, political, and economic limits set by national boundaries (see also section 3.2.).[10]

Market linkages: Second, cross-border externalities can arise even if there is no direct cross-border bank presence in a country through financial market integration. Specifically, direct interbank exposures but also common-asset exposures can result in negative cross-border externalities from a bank failure. Such cross-border spill-overs can be due to fire-sales of fragile banks and common asset exposures, but also informational contagion among investors. For example, further sovereign problems in the Eurozone may trigger a reassessment of all the sovereign risks across closely related economies, decreasing market values and widening sovereign bonds spreads, which may in turn affect banks in the region, even if they do not have direct exposure to the Eurozone. Even exposure by banks to the same asset markets as the failing bank in another country may be sufficient for this type of externality to occur. The more financially integrated financial systems are, the higher is this exposure.

Regulatory arbitrage: Third, cross-border externalities can arise from regulatory arbitrage. Banks have incentives to move to jurisdictions with lighter regulation or weaker enforcement. This can result in

[9] The concept of externalities refers to a situation where the costs or benefits of an activity are incurred by an unrelated third party. In unregulated markets, goods with positive externalities tend to be in short supply. Conversely, goods with negative externalities tend to be oversupplied since the full costs of the activity (e.g. pollution, systemic risk) are not borne by the suppliers alone but by society at large.

[10] Beck, Todorov and Wagner (2013) show that banks' cross-border activities distort supervisory incentives as evidenced by actual intervention decisions during the recent financial crisis. Specifically, cross-border banks with a high share of foreign deposits and assets were intervened at a later, more fragile state by their home country supervisors, while cross-border banks with a high share of foreign equity were intervened earlier at a less fragile state. These findings are consistent with the costs of bank failure being borne by foreign depositors and borrowers thereby providing the incentive for home country supervisors to delay intervention by exercising forbearance.

negative externalities for the host countries, if lighter regulation or weaker enforcement leads to bank fragility or failure.Altogether circumvention of supervisory oversight due to regulatory arbitrage (e.g., on licensing requirements, reporting standards and observance of prudential regulations) can have a pervasive impact on the solidity of the banking sector and is a major concern particularly in less developed and smaller economies where supervisory capacity is limited.[11]

Currency unions: Finally, specific cross-border externalities arise within monetary unions since a country cannot simply devalue its currency to regain competitiveness following a shock and hence may need to tap the resources of other countries in some form or other. The costs from asymmetric shocks that affect members of a currency union to a different extent are thus much higher in monetary unions.[12] Further, relying on a common lender of last resort might result in a tragedy of the commons problem, as it is in the interest of every member government with fragile banks to "share the burden" with the other members through, e.g., drawing on liquidity support by the joint lender of last resort. It is important to note that this externality applies at the systemic level, rather than just for individual institutions. The costs arising from this burden sharing, or rather burden shifting, in monetary unions increases in line with the size of the banking systems and the interlinkages across borders within the union. This externality might be especially relevant for smaller countries in currency unions and for countries with oversized (relative to their overall economy) banking systems. An example are countries that are completely euroized, such as Montenegro or Kosovo, as they effectively cannot exercise their lender of last resort responsibility.

In summary, cross-border externalities of bank failure distort the decision process of national regulators and supervisors and not only in the context of bank resolution decisions, but possibly also during regular supervision and regulation. These distortions are exacerbated by the asymmetry in interests and powers between different supervisors as we will discuss next.

3.2. Diverging interests and powers across home and host countries

Home country supervisors of multinational banks supervise on a consolidated basis, which gives them a more important role, more knowledge and thus also more power than host country supervisors. Consolidated information, however, relies to some degree on cooperation between home and host country supervisors, especially for the exchange of soft information. Memoranda of Understanding (MoU) have typically been used to facilitate the flow of information on a continuous rather than ad hoc basis and authorize supervisors to exchange confidential information, even though they are not legally binding. However, the protection of financial and national interest as well as asymmetric information availability across home and host country supervisors can skew decision-making processes in favor of the former and at the expense of the latter.

Beyond the information asymmetries, there are other asymmetries in the interests and relative powers of home and host country supervisors. The differences in interests are especially striking for small host countries, for whom the subsidiaries of multinational parent banks are often of systemic importance and thus the stability of the bank a high priority, while the host country operation of the bank is not material for the parent bank and thus of lower priority for the home country supervisor.

The diverging interests become even clearer during times of distress (D'Hulster, 2012). If the problem arises in the parent bank, the home country supervisor has strong incentives to delay and minimize

[11] Since the global financial crisis, the Basel Committee has developed a Regulatory Consistency Assessment Program, focusing on timely and effective implementation of its standards. The FSB is also performing regular peer and thematic reviews. These efforts have contributed to a clear improvement in implementation monitoring in BCBS and FSB member countries.

[12] A similar need to tap common resources might arise if the banking system is too large relative to fiscal revenue, and thus becomes too-big-to-save, as the examples of several countries within the Eurozone have shown (Bertay, Demirguc-Kunt and Huizinga, 2011).

information sharing (especially if the host country subsidiary is of material importance for the parent bank), while the host country supervisor has strong incentives to ring-fence and thus prevent local assets from being up-streamed to offset losses in the parent bank's financial position or in other parts of the group. If the problems arise in the subsidiary, on the other hand, the home country supervisor has incentives to share information with the host country supervisor (if the subsidiary is of material importance for the parent banks), while the host country supervisor has incentives to overstate the problem vis-à-vis the home country supervisor (possibly triggering capital and liquidity support from the parent) but also to ring-fence. Ultimately, in times of distress the interests of home and host country supervisors are not aligned.

And while the host country supervisor can try to ring-fence the subsidiary in times of distress, this is often difficult to do given the organizational interdependence (such as common IT platforms and centralized back offices) across the bank. This asymmetry in relative power is further intensified in Europe by the fact that home country supervisors in Western Europe have longer and deeper experience in supervisory cooperation and generally more financial strength than host country supervisors in CESEE. There might also be a political dimension for EU candidate countries, it is delicate for a candidate country to challenge EU home supervisors and supervision practices, particularly while relying on EU-funded technical assistance.

Before the global financial crisis, many countries did not have bank resolution regimes and most relied on corporate insolvency regimes to deal with failing banks. Even when resolution regimes were in place, for instance in the United States (US), they were nationally based, complicating the resolution of failing financial institutions active in multiple jurisdictions. This resulted in many breakdowns in supervisory cooperation during the crisis. Since then, international efforts have focused on developing effective resolution regimes with the Financial Stability Board's (FSB) Key Attributes laying out the international standard. At the global level, crisis management groups (CMGs) and resolution colleges have been established.

An effective resolution regime should be able to minimize the systemic damage caused by an orderly collapse of an individual bank without exposing the tax payer to the risk of loss or creating perverse incentives to take aggressive risks. One of the key features of post crisis resolution regimes is a move away from bail-outs to ensure losses are born by shareholders and creditors (including via bail-in).

To do this, the regime must provide authorities with the tools to safely and quickly ensure the continued performance of the bank's essential functions, including uninterrupted access of depositors to their funds. Resolution plans and resolvability assessments are to be drawn up to facilitate the swift resolution of a financial institution and to limit contagion effects and disruption in financial markets. While this playbook sounds attractive and fair on paper, the practical application in a crisis remains uncertain.

4. Regulatory reforms in the EU and the Eurozone

The post-crisis global reform initiatives have been translated into a new EU regulatory framework. Prompted by the Eurozone crisis, the Eurozone countries moved beyond these reforms and established a supranational supervision and resolution framework to address the externalities arising from the strong ownership linkages across banking systems in the EU and the close integration of financial markets. While open to all EU members, currently only Eurozone countries participate, reflecting the additional externality coming from cross-border banking within a currency union.[13]

This corpus of EU regulations, supervisory practices, and procedures, as well as cross-border cooperation requirements, y are applicable both at an individual and consolidated level. Hence, they are also relevant for non-EU hosts. The most relevant regulations for EU banks and the scope of their applications are summarized in Table 4.

Table 4: EU Prudential Rulebook

Area	Main content	Scope of application			Waiver
		Consolidated basis	Solo basis	Branches	
Capital	• Definition of CET1, T1 and TCR • Minimum ratios • Definition of risk-weighted assets (RWAs) • Capital buffers • Pillar 2 capital requirements • Leverage ratio (2019)	✓	✓	×	Parents and subsidiaries on a solo basis Only domestic
Liquidity	• Definition of High-Quality Liquidity Assets (HQLA) • Minimum liquidity coverage ratio (LCR) ratio • Other requirements	✓	✓	×	Parents and subsidiaries on a solo basis Domestic and cross-border
Governance	• Fit & Proper for key function holders • Group remuneration • Risk management standards	✓	✓	×	No waiver
ICAAP & ILAAP	• Internal capital and liquidity planning • Economic needs • Capital and liquidity targets	✓	✓	×	No waiver
Supervisory powers	• Sanctions • Early intervention measures • Supervisory measures	✓	✓	✓	N/A
Recovery planning	• Definition of measures to overcome a crisis • Recovery indicators	✓	×	×	N/A

[13] This externality became clear at the height of the Eurozone crisis in 2011/12, when regulators across the region tried to ring-fence local subsidiaries and parent banks considering denomination risk..

4.1. Supervisory processes and procedures in the EU

The European Banking Authority (EBA) has played a major role in the harmonization of supervisory processes and procedures across the EU. As part of the banking union, the harmonization process has evolved to reach a uniform standard since the establishment of the SSM. The supervisory work is based on regular processes and procedures (Table 5 and Annex for details), which include an annual Supervisory Examination Process (SEP), an annual Supervisory Review and Evaluation Process (SREP), annual stress testing, an annual internal capital adequacy assessment program (ICAAP), an annual internal liquidity adequacy assessment program (ILAAP), an annual review of the recovery plan, and – ad hoc – internal risk model validation and fit and proper assessments of the new members of the board, senior managers or other key function holders.

Table 5: Supervisory processes and procedures

Area	Frequency	Content	Outcome	Scope
SREP	Annual	• Business Model Assessment • Capital Adequacy • Liquidity and Funding • Internal Governance • Risks to capital	• Supervisory score • Pillar 2 requirements • Other requirements	• Consolidated • Not applicable to branches
SEP	Annual	• On-site inspections • Off-site inspections • Others	• Planning for the supervisory year	• Consolidated • Applicable to branches
Stress Testing	Annual	• Capital Adequacy in a stressed scenario	• External evaluation of capital levels	• Consolidated • Not applicable to branches
ICAAP / ILAAP assessment	Annual	• Review of the ICAAP / ILAAP process	• Opinion integrated into SREP	• Consolidated • Not applicable to branches
Recovery Plan review	Annual	• Revision of the group recovery plan	• Supervisor assessment letter	• Consolidated • Not applicable to branches[15]
Internal Model validation	N/A	• Validation of capital, market, operational and others capital models	• Validation report	• Consolidated • Not applicable to branches
Fit & Proper	N/A	• Assessment of the experience, reputation and professional background of members of the board and other key function holders	• Fit & Proper report	• Consolidated • Individual

Most of these supervisory activities are conducted on a consolidated basis for banking groups with a cross-border presence. EU regulations impose mandatory cooperation and coordination between supervisors when performing these tasks,[16] including obligations on information exchange and sharing, both in normal times and in emergency situations. EU consolidating supervisors and the other EU competent authorities involved in the supervision of the banking group shall also enter into written cooperation and coordination agreements.

The EU regulatory framework establishes that several decisions should be taken jointly by the consolidating and host supervisors within colleges. The main features of these decisions are outlined in Table 6 and further described in the Annex.

[15] Recovery plan review could be asked on individual basis in the case of EU cross-border banking groups.

[16] This externality became clear at the height of the Eurozone crisis in 2011/12, when regulators across the region tried to ring-fence local subsidiaries and parent banks considering denomination risk.

Table 6: Joint Supervisory Decisions within EU Colleges

Joint decision	Content	Deadline	No joint decision is reached	EBA mediation
1. Joint decision on capital	Consolidated and individual / subconsolidated institution specific capital requirements	4 months	1) Consolidated supervisor to decide on consolidated basis 2) Host supervisors to decide on individual / subconsolidated basis	Binding
2. Joint decision on liquidity	Consolidated and individual / subconsolidated institution specific liquidity requirements	1 month	1) Consolidated supervisor to decide on consolidated basis 2) Host supervisors to decide on individual / subconsolidated basis	Binding
3. Joint decision on internal models	Validation of first use and significant changes on Credit Risk (IRB), Counterparty Credit Risk (IMM), Market Risk (VAR) and Operational Risk (AMA)	6 months	Consolidated supervisor to decide on both consolidated and individual / subconsolidated basis	Binding
4. Joint decision on significant branches	Determination of a cross-border EU branch as "significant"	2 + 2 months	Host supervisor decides	No mediation
5. Recovery Plan	Assessment of the Group Recovery Plan, and measures regarding Recovery Plan	4 months	Home supervisor decides on consolidated basis.	Binding
	Decision to require an individual Recovery Plan		Host decides on individual Recovery Plan	Non Binding
6. Group financial support	Approval of the agreement	4 months	Consolidated supervisor decides	Binding
7. Authorisation of actual group financial support	Allowing or prohibiting/restricting the requested support	5 days	Decision is made by the providing entity	Non-binding

EU regulations require the following tasks to be conducted by the EU supervisory colleges:

- *The **mapping exercise** performed by the home supervisor, which allows a better understanding of the geographic footprint of the banking group and its corporate structure.*

- *Agreement on the **SEP**, which covers the activities to be carried out during the year by both the consolidating supervisor and the host authorities.*

- *The potential **entrustment of tasks and delegation of responsibilities** across the different authorities of the supervisory college, to avoid the unnecessary duplication of supervisory requirements.*

- *The **group risk assessment**, including the liquidity risk assessment as performed by the home supervisor. The risk assessment is needed to reach a joint decision on the capital and liquidity requirements, since additional Pillar 2 requirements and other supervisory measures are based on the outcome of this risk assessment. The group risk assessment should follow a standardized reporting template, usually including the evolution of all risk categories and forward-looking views on all the risk elements. It (the risk assessment) also covers conclusions on the risks and vulnerabilities faced by the group. In most of the supervisory colleges, a significant amount of time is devoted to discussing the risk assessments performed by the different participants in the supervisory college.*

- *Making **joint decisions** (open to binding EBA mediation as outlined in Table 6) on institution-specific capital and liquidity requirements, on the assessment of the group recovery plan, on group financial support, and on internal model validation.*

- ***Contingency planning for emergency situations,** including the exchange of information on early warning signs, potential risks and vulnerabilities, and establishing a college framework for emergency situations.*

- ***Management of emergency/crisis situations:** including leading a coordinated response by the consolidating supervisor to crisis situations.*

Progress in the development of some of these tasks is more advanced than in others. In most of the supervisory colleges, the group and subsidiaries risk assessments are performed, and a significant amount of time is devoted to these discussions. The members of the college also participate in the joint decisions on capital, liquidity, and recovery plan; with the capital decision more developed that the others. The requirement to produce a SEP is only complied with through the compilation of the individual programs of the consolidating and host supervisors. There has been little progress on the roles of the supervisory colleges on crisis contingency planning and crisis management.

The EU home supervisor is responsible for establishing a supervisory college, with additional members comprising: (i) the competent authorities responsible for the supervision of subsidiaries, (ii) the competent authorities of host Member States where significant branches are established, (ii) central banks of Member States that are involved (in accordance with their national law) in the prudential supervision of legal entities but are not competent authorities, and (iv) the EBA. In addition, the home supervisor can, with the previous agreement of the other members, invite other authorities as observers. While their status varies between colleges and authorities, observers typically receive only partial information.

4.2. Bank Resolution in the EU

The EU framework for bank resolution, recovery, and partly also early intervention, is described in the Bank Recovery and Resolution Directive (BRRD).[18] It lays out the establishment of an independent resolution authority and the powers to ensure that failing banks are resolved in accordance with the resolution objectives. The policy objective of resolution is the continuity of critical functions to avoid significant effects on financial stability. This includes the protection of public funds by minimizing reliance on extraordinary public financial support, the protection of insured depositors and investors, and the protection of client funds and client assets. The so-called "failing or likely to fail" (FOLTF) test creates a standardized but flexible set of resolution triggers to ensure the application of the special resolution powers are taken early enough and justified by the "public interest test."

The BRRD has introduced several resolution tools not previously available to most Member States authorities. Through the sale of business, the resolution authority can transfer the shares of the bank or (part of) its assets and liabilities to a third-party private sector buyer. If no private sector buyer is available but the resolution authority still considers it is possible to sell the bank in the future, it may decide to transfer the (good part of) assets and liabilities of the failing bank, or its shares, to a bridge institution. The latter will hold those assets and liabilities until a sale and purchase transaction can be arranged. Importantly, the bridge bank will need to be managed and it is often challenging to find the relevant skills in the public sector. However, if there is no realistic prospect of finding a buyer, the resolution authority may pursue an open-bank bail-in through the bail-in tool, whereby the claims of shareholders and creditors of the bank are written down or converted into equity to absorb losses and provide the fresh capital the bank needs for ensuring the continuity of critical functions. Finally, any of these tools can be combined with the asset management company tool that, in some cases, allows the separation of illiquid and impaired assets from the failing bank to be transferred to a separate company or "bad bank".[19]

When applying resolution tools, the resolution authority has extensive resolution powers to take control of the bank and take over ownership rights. The resolution authority can write down, restructure, or convert the debt instruments issued by the entity, apply a moratorium to debt instruments, and stay termination rights. It can also require the continuity of operating services by third-party providers, appoint special managers, etc.

[18] For a detailed analysis see: Lintner, P (Hg), Understanding bank recovery and resolution in the EU: a guidebook to the BRRD, December 2017, World Bank, FinSAC.

[19] These resolution tools can be used in combination or individually, except for the asset management company which can be used only in combination with other resolution tools. For example, the resolution authority may bail-in shareholders and subordinated creditors of a resolved bank to absorb losses, and then use the sale of business tool to sell the bank to another private sector entity.

The BRRD requires several steps for resolution authorities to prepare for resolution including developing resolution plans that identify the preferred resolution strategy for the banking group. Resolution planning also requires the determination of the "points of entry" (the legal entities where the resolution powers are expected to be applied), resolvability assessments undertaking, and determination of minimum requirement for own funds and eligible liabilities (MREL) requirements (Box 2).

Figure 5: Resolution and resolvability planning

Box 2: Total loss absorbing capacity and minimum requirement for own funds and eligible liabilities, including setting criteria

TLAC and MREL and MREL-setting criteria

Total loss absorbing capacity (TLAC) for global systemically important banks (G-SIBs) vs the MREL under the BRRD

During the global financial crisis and the Eurozone crisis, regulators were reluctant to bail-in bond holders fearing contagion effects on financial markets. Consequently, post-crisis reforms included the introduction of TLAC and MREL requirements to ensure enough high-quality loss absorbing instruments are held by banks to facilitate bail-in.

The TLAC is required only for G-SIBs according to criteria defined by the FSB. A G-SIB should hold a TLAC amount no lower than 16% of its risk-weighted assets (RWAs) (or 6% of their leveraged exposure) from 2019 onwards and at least 22% (or 6.75% of their leveraged exposure) from 2022 onwards. For single point of entry institutions, the rules are complemented with the so-called "internal TLAC", by which the TLAC resources raised by the parent entity are also down-streamed, to a certain extent, to the "material subgroups" that make up the banking group (between 75% - 90% of the external minimum TLAC requirement that would apply to the material sub-group if it were itself a resolution group). In addition, the TLAC standards provide specific rules to calculate TLAC requirements for multiple point of entry institutions, considering that each point of entry within the group should raise its own resources.

The criteria for the eligible instruments include that the instruments should be paid-in, have a residual maturity of more than one year, should be directly issued by the entity (not through special purpose vehicles). A significant share of the eligible TLAC instruments should have a certain degree of subordination to operational liabilities on which the performance of critical functions depends (in general terms this are deposits and also derivatives), in order the enhance resolvability and reduce NCWOL risks.

MREL was first introduced by the BRRD in 2014, with the calibration criteria developed in a European Commission Delegated Regulation (DR 2016/1450 or DR). In principle, MREL is applicable to all EU banks and banking groups, not only G-SIBs. As opposed to TLAC, the calibration of MREL is flexible, lacking a specific minimum requirement. This means it has to be calibrated for each individual bank – at consolidated and individual entity level - by the competent resolution authority.

A bank's MREL requirement, is guided by the above-mentioned DR and should be calibrated taking into account two components:

- **A default loss absorption amount (LAA),** representing the quantum of losses an institution or group should be capable of absorbing. It is equivalent to the bank´s capital requirements; and

- **A recapitalization amount (RCA), defined as the amount necessary to implement a bank's resolution strategy.** In other words, if the bank is expected to be resolved under a bail-in resolution strategy, the RCA represents the resources that the bank would need to generate fresh capital through recapitalization to comply with the applicable capital requirements.

- **There is room to tailor MREL to bank-specific features.**
    - The leeway for adjusting the default LAA upwards or downwards is closely related to supervisory stress tests, the resolvability assessment and the SREP. For example, the resolution authority may not include in the LAA of MREL the capital requirements that are imposed as the outcome of a stress testing exercise.
    - The recapitalization amount can be adjusted downwards based on the preferred resolution strategy, the bank's business model, funding and risk profiles, as well as its resolvability assessment. For example, the default recapitalization amount may be adjusted downwards if the resolution strategy of the bank is expected to be based on a sale of business rather than on an open bank bail-in.
    - Additional adjustments to account for the contributions from deposit-guarantee schemes (DGS), a bank's size and systemic risk, and the exclusions of liabilities from a bail-in are possible.

The BRRD also defines the eligible instruments that comply with MREL, with requirements more flexible than for TLAC. An instrument would be eligible for MREL if it has been issued and paid-in, its residual maturity is longer than one year, and it does not arise from a derivative exposure. The ranking of the instrument should not be lower than senior – introducing the new subordinated class of "senior non-preferred"[20] - and the resolution authorities may introduce further criteria for ensuring that the instruments can absorb losses.

Finally, negotiations to modify MREL standards and to introduce TLAC for EU G-SIBs are ongoing. More detailed rules are expected in several areas, for instance clearer rules on MPE and SPE banking groups (including internal MREL), specific TLAC requirements (more consistency between capital requirements and MREL/TLAC requirements), and more criteria, especially regarding subordination, on eligible instruments for TLAC and MREL.

One critical issue in resolution planning, especially in the context of cross-border banks is the conceptual discussion of SPE vs. MPE resolution strategies.[21]

- *An SPE strategy identifies a single resolution group, composed of one resolution entity, i.e. the entity to which a single resolution authority would apply resolution tools, and the non-resolution entities controlled or owned by the resolution entity.*

- *An MPE strategy foresees the application of resolution tools by two or more resolution authorities to two or more resolution entities. In these cases, the banking group would be considered as divided in more resolution groups (each one with one resolution entity and the non-resolution entities controlled or owned by it).*

- *A combination of the approaches is also possible and foreseen under FSB standards and the Single Resolution Board (SRB) resolution planning manual.*

[20] Senior non-preferred debt ranks senior to regulatory capital instruments (CET1, AT1 and Tier 2) and other subordinated debt but junior to senior debt (such as deposits and ordinary creditors). See Directive (EU) 2017/2399 as regards the ranking of unsecured debt instruments in insolvency hierarchy

[21] FSB, Guiding Principles on the Internal Total Loss-Absorbing Capacity of G-SIBs ('Internal TLAC'), July 2017.

The choice of a particular strategy takes account of the existing structure and business model of the individual firm and relevant characteristics. In general, the SPE approach is more likely to be chosen by resolution authorities for banks that are centrally structured and operated, that are mainly funded through the parent company, and that can transfer losses from other entities of the bank to the parent company. On the other hand, the MPE approach is, in general, more likely to be suitable for banks that have material subsidiaries that are operating with limited interconnections to other resolution groups.

An SPE strategy is based on a consolidated approach to resolution where resolution tools are expected to be applied only at the level of the parent entity, which is called "resolution entity" for these purposes. The SPE approach is therefore, in principle, more adequate for closely integrated banking groups. Debt is issued by the resolution entity and downstreamed to other entities of the group, so only the shareholders and the creditors of the resolution entity are expected to absorb losses in resolution. To ensure that losses in the subsidiaries can be up-streamed to the resolution entity, an amount of so called "internal loss absorbing capacity" should be prepositioned on the subsidiaries' balance sheet or readily available to recapitalize any direct or indirect subsidiaries (for example, via collateralized guarantees). Currently, SPE is the predominant resolution strategy agreed among resolution authorities for G-SIBs and also for banking groups within the banking union. In case of capital needs of a subsidiary under SPE, the expectation is that the parent would step up to its rescue and therefore wouldn't be expected to enter resolution. However, in the extreme case, resolution action (or WDCC) may be needed to be taken by the host authority in case internal LAC needs to be formally converted and the internal resources provided by the resolution entity are not enough to restore the subsidiary.

If the subsidiary is identified as a resolution entity as part of a MPE strategy, shareholders and creditors of that subsidiary are expected to assume the losses following the application of the resolution tools. MPE is generally suitable for banking groups consisting of self-sufficient, autonomous financial subgroups operating in different countries with limited interconnections with other resolution groups. Hence, MPE banking groups typically consist of subsidiaries instead of branches, with local deposit bases or wholesale funding, raised using their own financial strength. There is typically a high degree of operational and IT flexibility through independent IT or centralized entities. From a resolution planning standpoint, this implies that the MREL of the subsidiary is in principle expected to be issued to third-party investors (external MREL) and both the group-level resolution authority and the local resolution authority would identify obstacles, related to the interconnections among the different legal entities that may impede the separate resolution of the subsidiary. Though it should be stressed, that internal LAC coming from the parent does not per se create an impediment to the subsidiaries' resolvability under MPE; it may create an obstacle for the resolvability of the parent if it entails a risk of contagion. So far, MPE has been selected as a resolution strategy in only a relatively small number of G-SIBs, most prominently Santander and HSBC.

While the legal requirements are the same under the BRRD for both SPE and MPE strategies , the MREL (and TLAC) structures will be different. As can be seen in Table 7, within a SPE banking group, the parent company (the "entry point") is expected to raise the MREL resources from third-party investors and then downstream them to other parts of the banking group. However, within an MPE banking group, the different resolution entities are in principle expected to raise MREL from investors (though there is no legal requirement). Other solutions may also be available to increase the LAC at local level (e.g. by retention of profits). These differences influence the calibration of the MREL amounts at the consolidated and bank individual level.

[22] The proposed amendments under Art.72b(2b) EU Capital Requirements Regulation 2013 do not exclude the option that MREL would come from within the banking group also under an MPE strategy.

Table 7: Minimum requirement for own funds and eligible liabilities and resolution strategies

Block	SPE	MPE
Scope of application	Consolidated RWAs	Sub-consolidated RWAs ("resolution group") Entry-point based
Calibration	Capital requirements + Recapitalization needs	Capital requirements (Sub-consolidated) + Capital requirements for MREL injected in other points of entry + Recapitalization amount for the same point of entry
Internal MREL	Yes, for subsidiaries to the resolution entity	Yes, for subsidiaries within the same resolution group to the resolution entity Not legally prohibited for resolution entry subsidiaries to another resolution entry entity i.e. the parent

As in supervision, there are many areas in resolution where cross-border coordination is needed and prescribed by the BRRD (Table 8).[23]

Table 8: Joint decisions in resolution planning

Joint Decision	Content	Deadline	No Joint Decision is reached	EBA mediation
Group Resolution Plan	Decision on group resolution, individual parent company, and subsidiaries	4 months	Group level resolution authority decides at group level Local resolution authority decides on an individual resolution plan	Binding, but fiscal impingement clause
Group Resolvability Assessment[24]	Decision on the resolvability of the banking group and identifying obstacles to resolution	4 months	Group level resolution authority decides at group level Local resolution authority decides an individual resolution plan	Binding, but fiscal impingement clause
Remove impediments to resolution	Adopt measures to remove impediments	4 months	Group level resolution authority decides on measures taken at parent level Local resolution authority decides on measures taken at local level	Binding
MREL	Determine MREL levels	4 months	Group level resolution authority decides on MREL at parent level Local resolution authority decides on MREL at local level	Binding

[23] For procedural details see for example: Lintner, P. (2018): De/centralized Decision Making Under the European Resolution Framework: Does Meroni Hamper the Creation of a European Resolution Authority?

[24] Technically the resolvability assessment is part of the same joint decision of the group resolution plan (as per delegated regulation 1075/2016).

Resolution colleges are the main instruments in the EU for cross-border cooperation, both for preparation and for the execution of resolution actions (Table 7). EU host authorities (i.e. resolution authorities but also finance ministries, competent authorities, and DGS authorities) of subsidiaries and significant branches have member status in the college. For EU G-SIBs, the BRRD allows that the functions of the resolution college can be assumed by the CMGs[25], without the need to set up two different and parallel structures.

Within resolution colleges, the group level resolution authority (e.g. the resolution authority of the ultimate parent entity) and the members (i) exchange information required for resolution planning purposes, (ii) develop the group resolution plan (including the joint decision), (iii) discuss the group resolvability assessment (including the joint decision), (iv) discuss the measures to remove the obstacles to resolution (including the joint decision), and (v) discuss MREL requirements (including the joint decision) as outlined in Table 7.

Colleges are also the forum for coordination and cooperation when resolution decisions involving cross-border banking groups are made. In resolution colleges, the group-level resolution authority and the other members decide on the need for a group resolution scheme, coordinate the public communication process of group resolution strategies and schemes (if applicable), and coordinate the use of financial arrangements (if needed). If there is no agreement on the group resolution scheme, the EBA may assist in reaching a joint decision.[26] In the end, each resolution authority may make its own decision for financial stability reasons, but it is obliged to provide a detailed reasoning to college members. Resolution authorities which reach a joint decision may go ahead in unison for the parts of the group under their respective jurisdictions.

Banking union. The Eurozone countries have gone further in centralizing supervision and resolution functions than the EU. The SSM was established when the ECB took over responsibility for bank supervision in the euro area in late 2014, following a year-long 'comprehensive assessment' to identify legacy issues. By that time, European authorities had agreed on the second pillar of the banking union – the SRM – to come into effect in 2016. The SRM is based on centralized decision making for resolution by the SRB. The latter has the national resolution authorities (NRA) as its constituent members, the European Commission and the ECB as observers, and the European Council in cooperation with the European Commission with veto powers. A centralized solution is yet to be established for deposit insurance.[27]

4.3. Cross border expansion: legal structures

The cross-border expansion of European banks has been achieved mainly through (fully-owned) subsidiaries. This has occurred despite the "passporting regime" allowing an institution that has been licensed as a bank in one Member State to use the right of establishment and the freedom to provide services within other Member States. European banks currently use branches mainly for very specific purposes, for example to (i) conduct certain wholesale or investment banking activities, (ii) raise wholesale funding in relevant financial centers, (iii) enter the banking market of a country (before acquiring a local bank or, less frequently, asking for a banking license to grow the business organically), and (iv) exclusively undertake cross-border commercial and retail banking, mainly in Member States.[29 30]

[25] CMGs have usually more competences than the resolution colleges. For example, one of their responsibilities is the assessment of the group recovery plan, which is typically done, in the supervisory colleges according to the European regulations.

[26] But no binding mediation is stipulated.

[27] Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 806/2014 in order to establish a European Deposit Insurance Scheme, COM/2015/0586 final.

[29] Nordic banks in their cross-border expansion to certain Baltic countries (e.g SEB, Danske Bank) and some Benelux banks in other EU countries (e.g ING).

[30] The use of branches for cross-border banking activities by EU banks outside the EU to engage in deposit-taking activities is virtually non-existent.

Box 3: Nordea

Nordea: branching and regulatory arbitrage

Nordea is a multinational banking group with a business model focused on retail and commercial banking throughout the Scandinavian region. It was the result of the merger of banking groups of Finland, Sweden, Norway and Denmark between 1997 and 2000. It has a relevant presence in the Baltic States and, to a lesser extent, Russia. It divested its Polish banking operations in 2013. It has been identified as a domestically important systemic institution in many of the countries where it is currently present.

Nordea´s model has been characterized by an integrated capital, funding, operating, and commercial model across the Scandinavian countries. Intra-group liquidity flows represent a very important share of the assets and liabilities of the main banking entities. In fact, the entities are so tightly integrated that they resemble branches instead of subsidiaries.

Nordea group has traditionally been headed by the Swedish banking entity, which means that the Swedish FSA (Finansinspektionen) has been its consolidating supervisor, while the European Central Bank (ECB) (for the Finnish subsidiary), Norway´s Finanstylsinet, and the Danish FSA have been, among others, its host supervisors.

Recently, Nordea´s managers were seeking to restructure the bank, including via mergers, with the objective to change consolidating supervisory responsibility of the Swedish FSA. In 2016, according to the press and public statements by Nordea´s chairman, the bank made an offer to take over Dutch state-owned bank ABN Amro. The potential transaction was justified by the possibility of some regulatory relief, since the combined bank would be in the Netherlands and, consequently, the consolidating supervisor would be the ECB.

However, the transaction was not successful. In 2017 and 2018, Nordea took two major restructuring steps. First, in January 2017, it merged its main banking entities into its Swedish bank. With the resulting structure, it became the most significant case of cross-border branching in the EU as it started to operate in Finland, Norway, and Denmark with branches instead of subsidiaries. Second, in September 2017 the board of directors of Nordea decided to start a re-domiciliation process from Sweden to Finland, with the objective to domicile its parent entity in the banking union.

It applied for a banking license in Finland, which was granted by the ECB in March 2018. And it merged the Swedish bank (the former parent entity) into the Finnish new legal entity. After merging the two banks, the parent entity would be the Finnish Bank (Nordea Bank AB) and, as a result, Nordea would perform also its banking activities in Sweden through a branch. The consolidating supervisor shifted from the Swedish FSA to the SSM.

According to Nordea, the decision to re-domicile in Finland, part of the banking union, would secure a fair, stable, and predictable regulatory environment for the bank on par with its peers. It was done to promote the interests of customers, shareholders, and employees. In particular, Nordea justified that the movement would result in material cost savings with a net present value between 900-1,200 million EUR, taking into account fees from the resolution fund, contributions to deposit guarantees, and other transitional effects. Whether the stricter approach to capital requirements by the Swedish FSA played a role in the relocation decision is of course difficult to judge.

In recent years the relative power of EU branch host supervisors, and particularly Eurozone hosts, vis-à-vis home country supervisors has improved. Branches may now be considered, for EU purposes, as (i) non-significant, (ii) significant, and (iii) significant-plus, according to criteria defined in article 51 of the Capital Requirements Directive (CRD) IV (Table 9). The consideration of a branch as significant does not alter the rights and responsibilities of the authorities under EU regulations and directives.

Table 9 illustrates the typical structures used in cross-border banking across the EU and the impact on supervision and resolution

Table 9: Regulatory classification of EU branches[31]

Branches	Criteria / Definition	Supervision regime	Supervisory colleges	Regulatory regime
Non-significant EU branches	Cross-border branch that does not comply with art. 51 CDRIV criteria.	• Home supervisor. • Limited involvement by host supervisor. • Home supervisor to provide information to host supervisor.	• No membership. • May be observers if proposed by consolidating supervisor.	• No individual capital, liquidity or governance requirements. • No individual ICAA, ILAAP or Recovery Plan.
Significant EU branches	• Cross-border branch that complies the criteria of art. 51 CDRIV: i. Deposit market share > 2%. ii. Relevant for the Member State payment system. iii. Significant number of clients. • Joint decision process. 4 months. • In case of disagreement, unilateral decision by host.	• Home supervisor continues to be responsible for the branch. • More information received by the host supervisor, both in normal and emergency situations	• Host authority member of the Supervisory College. • Requirement to set up a college if it did not exist according to article 51 (3) of CRDIV.	• No individual capital, liquidity or governance requirements. • No individual ICAA, ILAAP or Recovery Plan.
Significant plus branches	• Provision of critical services in the host Member State. • Relevance for the institution or the group. • "Intensification test" conducted by home and host.	Same than significant branches, plus: • Specific risk assessment for the branch. • More frequent spot checks and on-site inspections on the branch.	• Same as significant branches	• Same as significant branches

Recent strengthening of the relative power of EU branch host supervisors can be explained by several factors. First, the Solvency Directive[32] introduced the concept of a **significant branch** and gave host supervisors the right to participate in the supervision of the branch, and to receive timely information from the home supervisor. This amendment, now included in article 51 of CRD IV (see Table 9), defines the criteria to determine when a branch is significant. It then relies on a joint decision process to identify the branch as significant. This regime has been further strengthened by the new concept of the **significant-plus branch**, that requires a deeper involvement from both the home and the host supervisor in the oversight of activities performed through the branch.[33]

Second, the EU has continued to harmonize regulations ranging from prudential requirements to consumer protection, thus reducing compliance costs for banks and making the sharing of central services across borders easier.

Third, the implementation of the European banking union—with the abolishment of the traditional home-host division of tasks for significant institutions (SIs) and the harmonization of supervisory practices across the Eurozone—makes the branch structure more feasible, because responsibilities for supervision of both home and host functions are taken over by one supervisor, the ECB. Subsidiaries can thus be more easily converted into branches. However, the difference in regulatory regimes, most importantly the deposit insurance regime, remains the main obstacle to branching[34]. Moreover, the impact of digitalization on banks may render a network of physical branches less necessary with the massive use in retail banking of new digital distribution channels (internet, mobile banking, etc.).

[31] Note that for banking union countries the ECB does not take the role as host supervisory authority for a branch from a non-Eurozone bank. This role is assumed by the host Member State's National Competent Authority.

[32] Directive 2009/111/EC of the European Parliament and the Council of 16 September 2009 amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC (CRD II).

[33] The EBA has issued Guidelines on how the criteria and process to determine significant-plus branches and also on the content of the reinforced supervisory activities on the branch (EBA Guidelines on supervision of significant branches- EBA/GL/2017/14 of 16/02/2018).

[34] As it is explained below, the creation of the European Deposit Insurance Scheme (EDIS) is expected to be a decisive factor to take into account when deciding whether to establish a branch or a subsidiary.

Cross-border branching will most likely become more prominent in the Eurozone. Fostering concentration among Eurozone banks and creating truly pan-European banks is a European policy goal. In other words, the objective is to have fewer banking groups with a wider geographic reach and substantial use of cross-border branching. However, significant obstacles to cross-border branching in the rest of the EU remain. Despite recent strengthening, the rights and obligations of home and host supervisors with regard to branches still appear unbalanced. Furthermore, memories of the failed Icelandic banks raising deposits in EU countries through branches (where host deposit insurance schemes had to step in to protect local depositors) are still alive, resulting in reluctance against expansion through branches rather than subsidiaries.

For host countries outside the EU, where no passporting rights exist, supervisors will continue to oppose the provision of commercial banking services through branches, since it will limit their ability to supervise the local operations of the bank. In addition, from a home perspective, some EU supervisors have shown a clear preference for cross-border banking services to be conducted through separately capitalized and funded subsidiaries.

When non-Member States participate in EU supervisory colleges as hosts, they always do so as observers. EU host supervisors of non-significant branches, and other non-prudential supervisory authorities (like market/conduct supervisors or authorities in charge of anti-money laundering and terrorist financing supervision) may also be designated as observers.[36] The EU home supervisor also ensures that the members and observers of the supervisory college sign written cooperation and coordination agreements.

We discuss details of both SSM and SRM in Section 5.1 in the context of cross-border cooperation from the viewpoint of small Eurozone hosts countries. Table 10 summarizes the supervisory and regulatory arrangements for different corporate structures of cross-border banks within the EU, including responsible authorities, capital and liquidity requirements, MREL requirements, and which country is responsible for deposit insurance

Table 10: EU corporate structures for cross-border banking

Legal Entity/Structure	Authority responsible for supervision	Capital / Liquidity requirements	Authority responsible for resolution	MREL requirements	Deposit insurance
MPOE subsidiary	Host supervisor authority	Subject to capital and liquidity requirements	Host resolution authority	Subject to MREL	Host country
SPE subsidiary	Host supervisor authority	Capital requirements and potential waiver on liquidity requirements	Host resolution authority	Internal MREL	Host country
SPE subsidiary (Eurozone)	SSM	Capital requirements (future potential waiver) and potential waiver on liquidity requirements	SRB	Internal MREL, if applicable	Host country
Significant branch	Home supervisor authority, information sharing with host supervisor authority	Not applicable	Home resolution authority	Not applicable	Home country
Non-significant branch	Home supervisor authority	Not applicable	Home resolution authority	Not applicable	Home country

[35] That has been the case, for example, of the Austrian authorities (the Financial Market Authority and the OeNB). They publicly stated in 2011 that the foreign subsidiaries of the Austrian banks should restrict their loan-to-deposit ratio to levels lower than 110%, effectively limiting the amount of funding that can be down-streamed from the parent companies to those subsidiaries. Other supervisors have even more experience limiting the use of branches and intragroup funding for subsidiaries in banking groups, as the model for cross-border banking in Latin America developed by Spanish banks shows.

[36] In the context of the European banking union, national competent authorities represented in the Joint Supervisory Team also participate in the supervisory colleges as observers.

5. Cross-border cooperation in supervision and resolution - practice

Geographically, a legal and regulatory distinction can be made between three types of home-host country relations: (i) parent bank and subsidiary are both located within the Eurozone, (ii) parent bank and subsidiary are both located within the EU, but the subsidiary is not located in the Eurozone and (iii) the parent bank is located in the EU, the subsidiary is outside the EU. In the latter category, we distinguish between candidate and non-candidate host countries.

The distinction is critical in terms of institutional responsibility as well as application of the EU regulatory framework. For all EU authorities the same regulatory framework and automatic membership in colleges including binding EBA mediation applies. For the euro area the traditional home-host divided responsibilities are, however, largely centralized at the ECB/SRB. Non-EU subsidiaries or branches are within the scope of the home supervisor's consolidated EU requirements. Moreover, the consolidated and requirements may have an impact on the activities as well as capitalization and liquidity positions in the host country. Although, the binding legal and regulatory basis for coordination and cooperation in the EU colleges does not apply to non-EU hosts they may be granted observer status.

Particularly worrisome for host supervisors are those situations where they do not have timely and comprehensive access to relevant group information. This may occur when the consolidating supervisor is paying less attention to the bank's activities in the host country (due to the fact of its non-materiality to the group), is not conducting preparations for group-wide emergency situations, and no strong relationship between the consolidating supervisor and the host supervisor exists. In these cases, the host supervisor may decide to take ring-fencing measures to separate the bank from the rest of the banking group as a second line of defense.

That said, changes in business models following the crisis have made subsidiaries less reliant on funding from their parent companies, which can increase the effectiveness of potential ring-fencing measures taken by both home and host supervisors. It is important to differentiate between ring-fencing that is part of a policy framework, where the requirements have been consulted upon and are publicly disclosed, and sudden ad hoc ring-fencing decisions during a crisis. While legitimate and, in some cases, needed to protect host country interests, sudden ring-fencing measures usually result in suboptimal outcomes for both home and host countries in the longer term. In the case of host countries, these actions can result in underinvestment by foreign groups in their host country subsidiaries or even force them to divest their ring-fenced banking businesses. In the case of home countries, ringfencing may produce a suboptimal capital allocation, where ringfenced subsidiaries may allocate too much capital at the expense of the parent institution, and even force the subsidiary to take on too much risk to reach an acceptable return on the invested capital.[37]

In the next section, effects of EU supervision and resolution regulation of cross-border banks will be analyzed from the viewpoint of (i) small host countries inside the Eurozone, (ii) small host countries that are non-Euro EU member states, and (iii) small host countries that are not members of the EU. In each section, we discuss first the framework for supervisory cooperation, then for cooperation between resolution authorities, and conclude with specific concerns of small host countries and possible reactions by these countries.

[37] A more detailed analysis of ring-fencing measures for the home supervisor, the host supervisor, and financial stability can be found in D'Hulster and Otker-Robe (2015).

5.1. "Eurozone small hosts"[38]

The Eurozone countries have gone further in centralizing supervision and resolution functions than the EU. The implementation of the banking union has resulted in the elimination of the traditional "home-host" distinction for significant institutions as all responsibilities are attributed to the SSM/SRM.[39] Thus, for a cross-border banking group headed by a Eurozone bank where one of its subsidiaries is based in a host Eurozone Member State, the ECB (SSM) is the supervisor and the SRB (SRM) the resolution authority for both the parent entity and the subsidiary, even if they are located in different Eurozone Member States. The SRM is supported by a single resolution fund (SRF), ex-ante financed by annual contributions paid at solo level by all credit institutions and certain investment firms established in the 19 SRM Member States.[40]

5.1.1. Overview: Banking supervision in the Eurozone

The SSM is the authority responsible for the supervision of significant Eurozone banks. It relies heavily on the resources of national supervisory authorities, which gives them an opportunity to be heard as they can voice any concerns through their membership of the Joint Supervisory Teams (JSTs) tasked with the day-to-day supervision of banks and banking groups. Hence, the national host supervisors retain access to relevant information, even though in practice they have lost decision power. National supervisory authorities still participate as observers in ECB supervisory colleges as they are members of the JSTs. Observers cannot vote in the decisions of the college.

The SSM exercises supervision both at the group level as well as at individual entity level ensuring that the subsidiary has sound levels of capital and liquidity and that its internal governance is effective. The SSM conducts the SREP and decides on other supervisory measures with regard to the group at consolidated level, but also to the subsidiary at solo or sub-consolidated level. Similarly, the ECB is the authority in charge of deciding on intra-border capital and liquidity waivers on individual basis to parent entities and banking subsidiaries across banking groups.[41]

The SSM is now also the responsible body for ensuring that distressed banks are addressed in a timely manner. It reviews the annual group recovery plan, demanding an adequate coverage of all the material legal entities (MLE) included in the group regardless of whether they are located within or outside the EU.[42]

[38] The term is used for mere simplification purposes. Conceptually Eurozone small host authorities are non-existent as both the responsibility for the group as well as for the individual entities located in the Eurozone has been assumed by the SSM/SRM.

[39] Note that for BU countries the ECB does not take the role as host supervisory authority for a branch from a non-BU bank. This role is assumed by the host Member State's National Competent Authority.

[40] Banks that don't come under the SRBs remit are to pay (lump sum) contributions to the SRF. If there is a need for resolution funding for these banks, they would ad hoc come under the SRBs responsibility rather than NRAs.

[41] Currently, the CRR only considers the possibility of granting a capital waiver to a subsidiary when both the subsidiary and the parent entity are located in the same Member State (intra-border capital waiver). Nevertheless, under CRR2 EBA is mandated to review this issue (the original Commission proposal included the possibility for waivers to a subsidiary when its head office is in a different Member State than the parent entity (cross-border capital waiver). With regard to liquidity requirements, the CRR already considers the possibility of granting both intra-border and cross-border waivers, through what is known in the regulation as "liquidity sub-groups". If granting a cross-border capital waiver to a subsidiary were to become reality, the SSM could issue waivers for subsidiaries in small host countries on their solvency requirements. As a result, a cross-border banking subsidiary with waived capital and liquidity requirements (and, with a guarantee from the parent entity) could become the prime example of future European banking group structure with more prominent cross-border branches.

[42] The consideration of a subsidiary being an MLE is unrelated to the decision if a third country subsidiary is considered "significant" in the host country to access to the Supervisory College.

5.1.2. Overview: Bank resolution in the Eurozone

With the establishment of the SRM,[43] the SRB is the authority responsible for ensuring that the concerns of both home and host countries are considered.[44] However, a strong role for the NRA in the execution of resolution decisions as well as in the planning phase remains. NRAs, as part of internal resolution teams led by the SRB, are deeply involved in drafting resolution plans, resolvability assessments, communicating with banks, engaging with them, addressing their doubts, but in accordance with the general policies and criteria approved by the SRB (following discussions in its plenary session and sub-committees where every NRA within the banking union is represented).[45]

The general principles that underpin the SRM establish that its decisions and resolution actions should take into consideration and carefully balance the interests of all participating Member States.[46] Decisions on individual bank matters are taken by the SRB's extended executive session formed by the four SRB Board Members, the SRB Chair and the NRAs concerned. If no consensus can be reached, the five permanent members have the power to decide on bank individual matters.[47] In addition, the European Commission and European Council have veto rights on SRB decisions on resolution actions (not in the planning phase), which raises some concerns on whether decisions can be taken quickly enough and whether political and non-stability concerns will reduce the efficiency of the decision process.[48]

The Eurozone NRA concerned, together with the SRB, make up the internal resolution team. They jointly perform all the activities required to conduct resolution planning, and hence host country resolution authorities, even from small hosts, are also fully involved in the planning process.[49] Internal resolution teams have become a channel through which small Eurozone hosts can voice their concerns and protect their interests in case these are not aligned with the SRB´s. The participation in internal resolution teams by small hosts has resulted in increased group information flows for them. However, in the resolution colleges established by the SRB as the home authority, NRAs have only observer status and cannot vote in the decision-making processes as this power is centralized at the SRB.

The SRB is also the authority in charge of conducting group resolvability assessments, setting MREL requirements, and identifying and removing obstacles to resolution. The SRB is thus the authority that decides on the distribution of MREL requirements into the different legal entities that make up the Eurozone group both at the consolidated and individual level.

[43] See 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 SRM and a SRF and amending Single Resolution Mechanism Regulation (SRMR) No 1093/2010.

[44] For the specific distribution of responsibilities between SRB and NRAs, see article 7 of SRMR.

[45] The cooperation obligations within the SRM are outlined by article 31 of SRMR.

[46] See article 6(3) of SRMR. According to this article "when making decisions or taking action which may have an impact in more than one Member State, and in particular when taking decisions concerning groups established in two or more Member States, due consideration shall be given to the resolution objectives referred to in article 14 and all of the following factors:

- a) The interests of the Member States where a group operates and in particular the impact of any decision or action or inaction on the financial stability, fiscal resources, the economy, the financing arrangements, the deposit guarantee scheme or the investor compensation scheme of any of those Member States and on the Fund;
- b) The objective of balancing the interests of the various Member States involved and of avoiding unfairly prejudicing or unfairly protecting the interests of a Member State;
- c) The need to minimize a negative impact for any part of a group of which an entity referred to in article 2, which is subject to resolution, is a member."

[47] Like, for example, the setting of MREL or the taking of actual resolution schemes by simple majority without the NRAs concerned.

[48] In the first and so far, only resolution case decided by the SRB on the failure of Banco Popular the decision making process proofed efficient, though it has to be noted that this particular case did not involve (public) burden sharing i.e. the use of the SRF nor cross border issues.

[49] Notwithstanding that, as can be expected, the NRA of the home country will be the most involved in the process.

Once a bank is considered FOLTF by the supervisor, the SRB will decide if the public interest test is fulfilled before placing it in resolution. Then, it decides on the resolution scheme to be applied to the resolution group, also selecting the specific resolution tools to be applied to the resolution entity under its authority (limited by Commission and Council veto rights)[50].

These tools and powers stipulated in the scheme will be exercised by the NRA, according to a model of centralized decision-making and decentralized execution. The SRB also decides on the use of the SRF, provided that the resolution scheme complies with the minimum requirements for tapping it for capital restoration purposes (i.e. losses have been absorbed by shareholders and creditors up to 8% of total liabilities and own funds). Nonetheless, there are limits to what the SRB can agree; in particular, it cannot make decisions or take actions that either require Member States to provide extraordinary public financial support or impinge on the budgetary sovereignty and fiscal responsibilities or the Member States.[51] This is aligned with the overarching principle of the BRRD as well as international standards to avoid public bail-outs. Still, the lack of burden sharing arrangements and the limitations to use the SRF might become an obstacle to taking timely and effective resolution decisions in case of contagion.

One of the outstanding issues in the design of bank resolution in the Eurozone is how to ensure sufficient resolution funding including a possible public backstop. The current legal and institutional framework has the proper mechanisms to ensure that losses can be absorbed, and fresh capital can be provided by shareholders, creditors or the SRF. However, if a bank under resolution becomes illiquid, it is not clear where the funds will come from, which presents a fundamental risk to bank resolution in the Eurozone. Although funding could come from different sources (deposit guarantee scheme, the SRF, or national central banks through emergency liquidity assistance) each of these comes with drawbacks, in particular when funding for entities from different Member States is required.

5.1.3. Implications of the new framework for "eurozone small hosts"

The current model of bank supervision and resolution in the Eurozone has benefits for small hosts, as the integration into the SSM/SRB has resulted in harmonized and more comprehensive supervisory and resolution methodologies[52].

One main goals of the Eurozone is to foster integration between Eurozone banks, thus creating a truly single banking market, and to encourage the creation of truly Eurozone banks. Although not explicitly expressed, this goal also influences supervision and resolution planning which has some consequences for the small host authorities within the Eurozone. In particular:

- *More centralized supervision is more biased in favor of the consolidated level and may favor branches against subsidiaries. Many supervisory processes are performed at the consolidated level (SREP, stress testing, etc.); and while they also cover Eurozone subsidiaries, the attention paid to the sub-consolidated or solo level has decreased significantly. This may also influence the possibility of granting waivers to cross-border Eurozone subsidiaries (currently available for liquidity but not for capital) and, more importantly, the conversion of subsidiaries into branches across Eurozone countries.*
- *Host authorities of eurozone subsidiaries of parent banks that fall under the SRBs remit have no longer legal responsibility on resolution planning nor the taking of resolution decisions as this is centralized under the SRM. Resolution planning also includes decisions on the quantity and quality of (internal) MREL. If no agreement can be found between the authorities concerned, it is finally up to the 5 permanent Members of the Executive Session of the Board to decide on a resolution plan under the SRMR and to strike a balance between different national interests within the eurozone authorities including on entity individual MREL setting and the preparation of a resolution scheme (for the Commission) at parent and subsidiary level.[53] In most cases, resolution action is envisaged at parent level as most eurozone banks are following an SPE strategy within the Eurozone.*

[50] For details, see: Lintner, P. (2017) De/centralized Decision Making Under the European Resolution Framework: Does Meroni Hamper the Creation of a European Resolution Authority?

[51] See article 6(6) of the SRMR.

[52] Note that entity individual MREL is so far not set by the SRB and the framework in the Eurozone for internal MREL still needs to be developed, especially in light of the upcoming new EU regulations introducing the concept of the concept of 'resolution entity' and 'resolution group'.

[53] See Article 54 SRMR.

Requiring banks to structure themselves to comply with and be resolvable under a SPE at Eurozone level is based on banks' business structures, but could also contribute to changes in those business structures, if necessary. It may encourage further operational and financial integration in groups. This may translate to fewer restrictions on intragroup financial flows (subject to prudential rules, e.g. large exposures, and supervisory approval), in the choice of the group´s operating and IT model, etc. And, in the medium to long term, it may contribute to the conversion of subsidiaries into branches.

5.1.4. Challenges and potential reactions by "eurozone small hosts"

Despite the benefits of the Banking Union, small Eurozone hosts may still perceive that their concerns are not being dealt with properly. For example, they may consider that the liquidity or capital levels of the subsidiary are unsatisfactory, that the liquidity and funding model of the group is not in the interest of the subsidiary, that the dividend policy of the subsidiary is too aggressive, or that the crisis management capacities of the SSM as supervisor are not sufficiently well-developed. In these situations, they still might want to rely on their domestic powers to force banks to increase the capital, and liquidity, and to lower their risk profiles.

A potential future concern for Eurozone small hosts is that they may feel powerless to oppose the granting of cross-border liquidity and, when legally possible, capital waivers for their subsidiaries, since these authorization powers are, or may in future be with the SSM. They may feel equally powerless when the banking subsidiaries that received a waiver are converted into branches. And in resolution, when the SRB decides that the Eurozone banking subsidiary is part of the same resolution group/ point of entry, this may implicitly allow for free flows of capital and liquidity and thus the integration of different legal entities within the euro area.

While one goal of banking union is to facilitate more integrated banking groups and markets, small host country supervisors can be concerned that this goal is achieved prematurely as significant issues remain unresolved, such as the setting up of the European Deposit Insurance Scheme (EDIS), emergency liquidity assistance (ELA) provision by national central banks or public backstops in resolution funding. Small Eurozone hosts however still retain certain competences and powers. In particular:

- *The macroprudential authorities of Eurozone Member States ("Designated Authority") identify systemic institutions and set other systemic important institutions buffers. Some small host authorities have occasionally required higher capital buffers than other supervisors.*

- *Small Eurozone hosts may also adopt measures to address macroprudential risks at the level of that Member State, which may include gold-plating the capital, liquidity, or large exposures requirements, among others.*[54]

- *Host regulation may still require subsidiaries to draft individual recovery plans, even when a group recovery plan including the subsidiary has been drafted.*[55] *However, this is not applicable for branches or subsidiaries with a waiver.*

5.2. Non-Eurozone EU small hosts

Contrary to Eurozone hosts, other EU Member States retain their full competences as individual or sub-consolidated host supervisors and resolution authorities. This means that all the supervisory processes discussed in section 4.1. and applicable to the subsidiary are planned and executed by the host authority. Similarly, in terms of resolution, non-Eurozone EU host resolution authorities are responsible for the resolution of subsidiaries.

[54] See article 458 of CRR.

[55] The individual recovery plan may be only required in case the local regulations demand it. Otherwise, the requirement of an individual recovery plan would be subject to the final decision of the ECB, since it constitutes a joint decision, where the ECB has taken the competences from the national supervisory authority.

5.2.1. Overview: Banking supervision in the EU

The European regulatory framework provides for compulsory cooperation between home and host supervisors within the EU.[56] Small EU hosts are members of the supervisory college[57] of the banking group that the consolidating supervisor should establish.[58] Participation in these structures is essential as they are the legal forum where joint decisions are taken and coordination and cooperation between supervisors takes place. Joint decisions for instance on capital, liquidity, internal model validation, both on a consolidated and on an individual basis, are taken within the colleges.[59]

The involvement in these processes allows the small hosts to have a more comprehensive view of the capital and liquidity available at group level and how they are distributed across the different units of the group. The sharing of information by the home supervisor in the colleges is also important for another reason: the access to recovery plans, to ICAAPs, to ILAAPs, to SREP reports, and to risk assessments allows small EU hosts outside the Eurozone to gain insights into these SSM supervisory processes.

5.2.2. Overview: Bank resolution in the EU

The resolution authorities of non-Eurozone EU subsidiaries or significant branches (depending on their relevance in the host country[60]) are members of the resolution colleges, organized by the group-level resolution authority (usually, the SRB). As college members, they are granted access to group-level information, which is valuable for resolution planning purposes, and, at the same time, they participate in the joint decisions within the college, including those with regard to resolution plans, resolvability assessments, and MREL requirements.[61] However, the development of resolution plans, resolvability assessment, and MREL requirements is at an early stage for many EU countries, even though significant progress is expected in the coming years.

The typical small host concern of insufficient coverage of local subsidiaries or significant branches in the group resolution plan has been addressed by how the EU regulations define material legal entities.[62] One of the criteria used for determining the materiality of legal entities and branches (not to be confused by the "significant branch criteria in supervision) is "the importance of the entity to the financial system of at least one of the Member States in which they have their registered offices or operate".[63] This definition ensures that subsidiaries and branches are covered in the group resolution plan and resolvability assessment, even when they do not represent a significant share of the assets of the group.[64]

[56] See articles 114 and 117 of CRD IV.

[57] The consolidated supervisor should establish supervisory colleges for banking groups.

[58] To facilitate and establish effective supervision, the consolidated supervisor and the other competent authorities shall have written coordination and cooperation agreements (WCCA) in place, in according with article 115 of the CRD IV.

[59] This may not be the case if the group has set up a branch instead of a subsidiary in the host country. In this particular case, the supervisor may only be part of all these processes and receive information regularly if the branch is considered as "significant", according to the definition and decision-making process outlined by the CRD IV.

[60] For the significance criteria see Table 7. Other authorities from the host country will also be members of the resolution college: (i) the competent authority (host supervisor), (ii) the Minister of Finance, (iii) and the authority in charge of the deposit guarantee scheme.

[61] Until now there hasn´t been required to adopt a joint decision on a group resolution strategy for EU cross-border banks.

[62] See article 7(2) of the Commission Delegated Regulation (EU) 2016/1075 on the content of the recovery plan.

[63] ibid

[64] Like supervisory colleges, the inclusion of a subsidiary as a material legal entity in resolution or recovery plan has no effect on the consideration of a subsidiary as significant (in terms of its importance in the host country) to provide the basis for access to the College under Art 88 BRRD/51 CRD.

Even though it is not explicitly stated in the in the EU legal framework, authorities must make a choice between an SPE, an MPE, or a mixed approach for cross-border banking groups. They need to explain in the resolution plan to which legal entity resolution tools would be applied. For subsidiaries in the EU, but outside the Eurozone, the home (usually the SRB) and host authorities must find a common understanding for determining the resolution strategy. If disagreements arise, EBA mediation is available (see Table 9). Joint decisions between Group Level Resolution Authority (i.e. the SRB in most cases) and NRA are taken on (external) MREL at solo level for subsidiaries, and where there is disagreement it is the "host" NRA to decide, with the possibility for the Group Level Resolution Authority (GLRA) to recur to EBA binding mediation.[65] Vice versa the GLRA decides on consolidated MREL /at parent level open to EBA binding mediation by the host authority.

If the SRB / other EU home authorities and the local resolution authority jointly decide to include the EU banking subsidiary into the same resolution group as the parent (i.e. the resolution entity in this case), host supervisory authorities have incentives to give up ring fencing strategies. Still, also under an SPE approach, in a worst-case scenario, (prepositioned) internal MREL could not be sufficient and the parent not able or willing to provide further support, triggering the host authority to take independent resolution action being left with limited options/additional difficulties in light of the interconnectedness underlying an SPE approach.

Under an MPE strategy, the host resolution authority might still prefer a situation where it demands that the MREL is provided by the parent entity. However, for home authorities, this may be an obstacle as it may entail a risk of contagion. This is especially the case in small host countries with shallow capital markets where issuing loss-absorbing debt at sustainable prices is not always possible. Regardless of the underlying approach, host authorities have incentives to ensure high amounts and high quality of ex-ante pre-positioned internal MREL instruments are available in case of need.[66, 67] The SRB and other group-level resolution authorities can aim to restrict the risk of contagion (i.e. financial interdependencies including MREL) between resolution groups. Though host authorities are competent to define MREL for the subsidiary, the parent's supervisory or resolution authority could potentially prevent the parent from down-streaming capital or debt. In any case, decisions on MREL for both individual entity and consolidated level as well as general decisions on banks resolvability are subject to EBA binding mediation in case of disagreement between "home" and "host" authorities.[68]

If the subsidiary is assessed as a separate point of entry (MPE), the host resolution authority may identify obstacles stemming from the interconnections of the subsidiary to the rest of the banking group (IT connections, upstream financial exposures, centralized liquidity management by the parent

[65] Unless the host NRA has calibrated the external MREL of the subsidiary at a level within 1% of the consolidated MREL (safe-harbour clause). Also the BRRD2 Commission proposal foresees that a joint decision on the resolution strategy is taken by the home resolution authority and the NRAs of the non-resolution entities which form part of the same resolution group. If no agreement can be found between the group-level resolution authority and the NRAs concerned, the decision on external MREL is to be taken by the group-level resolution authority (taking into account the "host" opinion) and the host NRAs can refer the decision to the EBA for its binding mediation. The decision on internal MREL would be taken by the host NRAs.

[66] According to this model, the parent company may be effectively guaranteeing the balance sheet of the subsidiary, ensuring a recapitalization if losses arise and isolating the subsidiary´s creditors from these losses. The group level resolution authority may be, up to a point, interested in this model since these subsidiaries are usually small and if one of them fails the parent company would be, for different reasons (mainly reputational, but also financial), reluctant to let it fail. However, it may oppose any measure taken by the host resolution authority demanding a higher degree of autonomy of the subsidiary with regard to the parent company.

[67] Legal MREL requirements in such cases could be complied with, in form of write-down or conversion of capital (WDCC) of eligible capital instruments being triggered outside resolution at the point of non-viability (PONV)/FOLTF by the host authority (the expectation would be for the parent to recapitalize the bank without a conversion action by the resolution authority). This case may imply fewer restrictions on the interconnections between the subsidiary and the rest of the group, and the host may have additional flexibility to trigger WDCC/bail-in of the pre-positioned amount early enough. However, the unlikely case of lack of support from its (solvent) parent company (above the prepositioned amount) may result in separate resolution of the subsidiary, making it difficult to separate the subsidiary from the group. This situation is highly unlikely due to the high reputational risk incurred by the parent company but is not impossible, and can arise in situations where the failure of the subsidiary is mainly explained by political events in the host country or when the parent company does not have the financial capacity to support the subsidiary or several subsidiaries at the same time. See Box 6.

[68] The EBA published its first binding mediation decisions between two resolution authorities, the Single Resolution Board (SRB) and the National Bank of Romania (NBR) in June 2017.

company, centralized treasury, etc.) as it may have to enforce the separation of the subsidiary in case of resolution. In an MPE strategy, the services ensured by one resolution group to the other resolution groups should rather be the exception than the rule. However, some limited services could continue to be provided if there is no risk of disruption and contagion. The group-level resolution authority may find opposing these (ring-fencing) measures difficult if the subsidiary constitutes a separate point of entry. The provision of internal MREL (by the parent company) under an MPE approach to a certain extent dilutes the theoretical concepts underlying the difference to SPE and undermines the subsidiaries financial self-sustainability. However, if internal MREL is prepositioned in the same way as external MREL, the mere fact of parental support does not per se negatively affect a subsidiary's resolvability under MPE. However, this may be an obstacle for the parent in case it entails risk of contagion.

If resolution authorities do not agree with the group resolution plan, the resolvability assessment, the decision to remove obstacles to resolution, or the type or amount of MREL decision, responsibility falls back to the host authority to decide for the individual entity and to the home for the consolidated level. If the home authority (SRB) does not agree with the host authorities' decision or vice versa, it can refer the decision to EBA´s binding mediation, which is open to the fiscal impingement clause in some cases (see Table 8).

5.2.3. Implications of the new framework for non-Eurozone EU hosts

A common concern of non-Eurozone EU small hosts is that insufficient attention is paid by the SSM/ SRB to the systemically important subsidiaries in the host country if they do not represent a significant share of the assets, liabilities, revenues, or capital of the banking group. As illustrated by the survey responses reported in Box 4, typical examples are poor communication with host supervisory authority and poor follow up on proposed joint activities by the home authorities

Box 4: Survey of host country supervisors' views on cooperation with home country supervisors

Survey
This box presents the results of a survey among host country supervisors in Central, Eastern and Southeastern Europe (both EU and non-EU members).[69] Supervisory authorities were asked to rate the effectiveness of the co-operation with home country supervisors for systemically important foreign financial institutions. In all cases, foreign-owned banks are present in the form of subsidiaries. Austria, France, Germany, Hungary, Italy, but also Russia, are among the home countries of the most systematically important foreign-owned banks in these countries. Only 50% of the supervisory authorities are part of the relevant supervisory colleges and 40% of the resolution college. In the case of supervisory colleges, in about half the cases, the host supervisor is a member of the core college and in about half the cases only of the general college. Asked about the effectiveness of supervisory cooperation, six host supervisors answer "average", one "effective" and another "very effective". Two thirds of the host supervisors consider the information they receive in the supervisory colleges as sufficient and useful to undertake effective supervision in their country. There are information asymmetries between home and host supervisors. Few respond positively when asked whether home supervisors are willing to provide host supervisors with information they need or want. There are only a few cases where the home country supervisor performed an inspection of the subsidiary in the host country and informed the host supervisor. When it comes to joint supervision missions, in half of cases this is rare and in the other half it has yet to happen. In half of all cases, the host country supervisor could observe an inspection by the home country supervisor, but less than half stated that they receive the inspection report from the home supervisor. In most cases, host country supervisors often or always meet with home country supervisor, yet this is not necessarily the case for EU host country supervisors.

[69] Respondents were from Albania, Belarus, Bulgaria, Kosovo, North Macedonia, Moldova, Montenegro, and Romania.

When the host supervisor undertakes an inspection of a systemically important foreign subsidiary, half of the host supervisors communicate with the home supervisors in written form, none of them meets with the home supervisor. In only half of the cases, the host supervisors share the inspection report with the home supervisors. Half of the host supervisors invite the home supervisor to either observe or participate in an inspection. When addressing material supervisory matters regarding foreign-owned domestic systemically important banks, however, more than half of the host supervisors never or rarely communicate or consult with the home supervisors and none decides jointly on enforcement actions. This reflects the national mandate of supervisors.

When it comes to ring-fencing, most of the host supervisors state that the current set up does not allow for restructuring without the help of the parent group. According to the host supervisors, the parent bank would support its subsidiary with capital, liquidity and technical support and (to a lesser extent) statutory funds and subordinated loans. Foreign-owned domestically important banks are (so far) in none of the countries required to hold Loss Absorbing Capacity (LAC) which could be converted into equity in case of insolvency or bail-in. This is surprising since the BRRD was issued in 2015. And there is no practical experience with a foreign bank failure in the eight surveyed countries.

In summary, there is still only limited participation in supervisory and resolution colleges and limited information exchange, especially down-stream. On the other hand, there are not many options for host supervisors to ringfence their systemically important foreign bank subsidiaries.

In the following paragraphs, we discuss some recurrent issues.

a) ***Potential inadequacy of the branch regime for cross-border banking.*** *The lack of attention and communication by consolidating authorities is even more important when the parent company performs its activities in the host country through a branch rather than a subsidiary. While these concerns have been partly addressed by amendments to the prudential regime in the EU[70], local authorities may still perceive the attention paid by the home supervisor to the host country as insufficient. In addition, the development of cross-border commercial banking activities through branches may place significant stress on the financial safety net of the home country. Deposits raised in the host country will be covered by the home deposit insurance scheme, and creditors and depositors of the parent entity in the home country will be exposed to the losses of the branch.*

b) ***Dealing with powerful central institutions:*** *The EU small hosts must deal with the SSM or the SRB rather than national authorities. On the plus side, in countries with a significant share of Eurozone parents like Croatia, Romania, Czech Republic, and Hungary, the local authorities now have a single counterpart for all their subsidiaries, which should ensure more consistent approaches.*

   For some authorities that have, implicitly or explicitly, stated their intention to join the Eurozone and the SSM/SRB mechanisms (Bulgaria, Croatia), differing with the Eurozone institutions comes with political trade-offs. For example, there may be reluctance to call for EBA mediation. Box 5 summarizes some of the arguments in favor and against small EU non-Eurozone host countries joining the banking union.

Box 5: Why would EU small hosts join the European banking union?

WHY WOULD EU SMALL HOSTS JOIN THE EUROPEAN BANKING UNION?

Some non-Eurozone EU host countries have considered joining the European banking union prior to being part of the Eurozone. Romania, Bulgaria, and Croatia are considering applying for banking union membership. Some other countries (Poland, Czech Republic, and Hungary) remain opposed to joining the banking union, which (considering the high shares of foreign ownership in their banking sectors) may seem inconsistent at first.

[70] These include introduction of the prudential regime for significant branches, enhancement of the joint decision regimes, clarification of the roles of the supervisory colleges, and mandatory coverage of the material legal entities in the group recovery plan based also on the systemic relevance for the host country.

There are several arguments in favor of joining the banking union, including:

- Given the high share of ownership of Eurozone banking groups, contagion risks from the Eurozone may be elevated. Becoming part of the SSM and SRB can help to influence policy-making and participation in supervisory and resolution issues.

- The SRB may adopt a SPE approach for these subsidiaries, resulting in a „de facto" guarantee of the subsidiaries' external creditors by the parent company.

Nevertheless, there are also arguments against joining, such as:

- Since all the supervisory and resolution powers are (semi)centralized at the Eurozone authorities, there is a high risk of the "branchization" of their financial systems, especially when the banking groups are set in the Eurozone. The decreasing number of barriers (and having the same supervisory authority removes a significant one) to cross-border banking may contribute, as explained in previous sections, to the use of branches to conduct banking activities across the euro area.

- Host supervisors would largely lose their ability to impose higher institution-specific capital and liquidity requirements, among others, under the SREP and Pillar 2 rules.

- The host countries, considering the relatively small size of their financial systems when compared to others in the Eurozone (Germany, Italy, France, or Spain) may fear that their banks would not receive the required attention by the SSM. This may be the case particularly for domestic-owned banks and banking groups (e.g. PKO in Poland or OTP Bank in Hungary) that are under intense supervision by national supervisors but would be considered medium-size or small banking groups in the Eurozone.

- Poland and Hungary have targeted an increase in the domestic ownership levels of their banking systems in so called "banking nationalism" (Méro and Piroska, 2016). The transfer of banking supervision powers to the SSM may interfere with these objectives and the remaining domestic banks may be taken over by Eurozone banks since the authorization powers for mergers and acquisitions (M&A) transactions are transferred to the ECB.

- Many EU non-Eurozone countries, such as Czech Republic and Poland, have strong supervision practices and hence were not so affected by the negative fall out of the global financial crisis.

- Their small size relative to other participating countries may reduce their leverage and influencing powers in the ECB/SRB.

- The current weaknesses of the Eurozone, mainly the lack of a European Deposit Insurance Scheme and the lack of a liquidity backstop for banks under resolution, may make it less attractive to join.

c) ***Lack of representation of host countries interests in EU supervisory colleges:*** *As part of their participation as members in the SSM supervisory colleges, EU small hosts typically voice the following concerns:*

- *In the annual SEP the "combined component" is usually the simple consolidation of the individual SEPs of the supervisors of the college rather than a truly joint work program. For example, it is unusual to include joint inspection/examination programs that involve officers from both the home and the host supervisor.*

- *Crisis preparedness/contingency planning is still in a premature phase. Correspondingly, discussions between home and host supervision over intra-group financial support agreements have yet to take place.*

- *In some cases, discussion on the capital and liquidity levels of the banking group as part of the joint decision has not been comprehensive or some small hosts have not been invited to the college at all.[71] This is especially important for group liquidity when the liquidity and funding model of the subsidiary is linked to the group (i.e. a subsidiary dependent on the funding of the parent company, a subsidiary that up-streams the excess liquidity to the parent company, a centralized model for managing collateral, etc.).*

[71] See EBA Report on the Functioning of the Supervisory Colleges in 2017, published on the 16th March 2018.

d) ***EU resolution colleges:*** *The small EU hosts of both subsidiaries and significant branches have the status of members of the college, so they can attend the college meetings, receive the information shared within the structures of the resolution college, and participate in the joint decisions. Resolution colleges, alongside resolution authorities, are novel in the EU. So far, the participation of the non-Eurozone EU hosts has been positive in terms of information sharing between authorities and exchanging views on resolution planning, resolvability assessments and MREL.*

The participation of the EBA in the colleges and the number of college meetings by the SRB have contributed to harmonization. The role of the colleges in resolution cases is still to be tested as no relevant cross-border bank failure has taken place since bail-in entered into force.[72] *In addition, there is room for improvement regarding the content and the dynamics of the resolution colleges organized by the SRB acknowledging that cooperation is depending also on host authorities willingness to cooperate and the building up of capacities. Each part of the resolution planning process can be improved in terms of, for example, information shared, technical developments, and policy issues.*

e) ***Different views on resolution strategies:*** *As discussed above, the home and host resolution authorities may have a different understanding of what the main implications of being considered a separate point of entry are in terms of resolvability and the interconnections between the subsidiary and the other parts of the group, open to EBA mediation. For example, host resolution authorities may consider that a separate point of entry implies that the subsidiary should have independent funding and treasury functions, while the home resolution authority and other host authorities may consider it appropriate to adopt a proportionate approach with measures strictly adapted to the mitigation of the risk of contagion and to ensure operational continuity in case of resolution with MPE.*

These differences in view are increasingly important, and tensions between some authorities are mounting, as shown by public statements by certain resolution authorities. For example, the Austrian Central Bank (OeNB) Vice Governor recently stated that resolution authorities must cope with regional failures themselves; and that if the local resolution authorities insist that the MREL should be provided by the parent banks, then there would be a strong incentive for converting those subsidiaries into branches (reflecting the idea that MPE and provision of internal MREL between two resolution entities of the MPE are in principle conceptually incompatible). The host perspective was publicly raised by the Governor of the Central Bank of Romania, declaring that at least until the conditions for MPE strategies are met, parent banks should continue to provide support to their subsidiaries. Fully fledged MPE strategies might not be feasible in many small host countries considering the shallow capital markets and related difficulties in raising external MREL.

f) ***Excessive levels of NPLs and material sovereign concentrations*** *through their subsidiaries are currently two of the main common risks in the EU banking system. In this context, the SSM may decide that a bank should reduce its risk profile through the reduction of NPLs and the sovereign exposures. While in principle the SSM may enforce these actions at the consolidated level, these requirements shall be carefully considered to avoid negative spill-over effects in the host financial systems. Even though a joint decision does not exist for these measures, the consolidating supervisor should discuss bilaterally with the affected host supervisors and, when needed, within the supervisory college.*

Box 6: How mergers and acquisitions in the Eurozone may affect small hosts in the EU and other non-EU European countries

HOW M&A IN THE EUROZONE MAY AFFECT SMALL HOSTS IN THE EU AND OTHER NON-EU EUROPEAN COUNTRIES

As explained in Section 2, a handful of Eurozone banking groups (Unicredit, Intesa SanPaolo, Raiffeisen Bank International, Erste Bank Group, Société Generale, etc.) have relevant market shares in many small host countries across Europe. Some of these banks were the result of several cross-border banking mergers. For example, Unicredit was created following the acquisition by the Italian Group Unicredit (itself the result of merging a large number of Italian former savings banks) of several banks in other European countries.

[72] Spanish-based Banco Popular, resolved in 2017 by the SRB, had one banking subsidiary in Portugal and another one in the US. However, no resolution college had been set up at the time of the resolution.

In 2005, Unicredit took over the German bank Hypovereinsbank (HVB), which alongside a relevant market share in retail banking in Southern Germany, had many subsidiaries in the then fast-growing CESEE region. In 2000, HVB took a controlling interest in Bank Austria, a systemic Austrian bank with many subsidiaries across the region. These stakes, combined with the ones owned by Unicredit, created a banking group with very high market shares across the CESEE region. For example, in Croatia Unicredit had 25.7% market share and HVB 8.3% (34% combined market share) and in Bulgaria (market share of 24.3%, combining 14.3% of Unicredit and 10% of HVB).

One of the goals of the European banking union (and particularly of the SSM) is to foster cross-border banking M&A within the Eurozone, creating truly pan-European players that provide banking services across the region. However, in view of the many obstacles to these goals, not least the unfinished nature of the banking union itself, few cross-border transactions have taken place between banks since the European banking union was created (with some exceptions, like the takeover of Portuguese BPI by Spanish CaixaBank).

Some of the most relevant Western European banking groups for the region may further merge their operations, indirectly combining their already high market shares in many small host countries. This outcome would be far from ideal for the small host supervisors, reducing the number of players, creating even more systemic institutions, and having a potential negative impact on local customers that might see their options for banking services curtailed.

If this were to occur, consolidating supervisors (especially, the SSM) should pay special attention to the concerns of the host countries. They should engage with host authorities (EU and non-EU) at an early stage of the discussions and try to devise solutions to address the issues faced by small hosts. A possibility may be forcing the divestments of part of the business by the combined banking group. But this solution also has relevant challenges, especially in countries where there are not many relevant players interested in entering the banking market.

5.2.4. Potential reactions by non-Eurozone EU small hosts

In cases where EU small hosts perceive that their interests are not sufficiently protected by participation in supervisory colleges and coordination and cooperation by home authorities, they may adopt additional measures to ensure the subsidiary or sub-group under their supervision is well-protected from a potential crisis in the parent company. In particular:

- *Like Eurozone hosts, the designated authority of the Member State is responsible for identifying systemically important domestic institutions and for setting the capital buffers for them. Some EU small hosts have included relatively high levels of capital buffers compared to other Member States, and some have used other regulatory instruments to increase the capital levels of their financial system. For example, in the case of Intesa San Paolo, the Italian authority has determined a 0.75% D-SIB buffer on a consolidated basis, while the Croatian authorities have placed a 2% D-SIB buffer on the local subsidiary. That said, host authorities are facing a balancing act with their banks, as they have no defense against the threat of conversion of subsidiaries into branches.*

- *EU hosts retain the ability to impose supervisory measures and to require institution-specific Pillar 2 requirements in terms of capital, liquidity, and other supervisory measures, even for cross-border banking groups, in case they cannot reach joint decisions on these requirements within the supervisory college.*[73]

- *Some EU hosts may seek to ensure more independence from the parent companies. This may include requiring a higher number of independent members of the board of directors/supervisory board of the subsidiary, more independent IT and operations structure, or a self-sufficient funding structure. Some supervisors have also required the listing of the subsidiary on the local stock exchange.*[74]

[73] Experience on the operation of supervisory colleges shows that the consolidated supervisory authority is unlikely to challenge the capital and/or liquidity levels required of the bank on an individual and consolidated basis while host supervisors are also unlikely to challenge the consolidated capital and liquidity requirements of the banking group, as proposed by the home supervisory authority.

[74] See the case of Poland. Through the listing of the subsidiary, the autonomy and independence of the subsidiary with regard to the rest of the group may increase naturally due to corporate governance and disclosure requirements that are applicable to listed companies. A situation where some foreign-owned banks also have minority shareholders and are listed in the stock market also happens, like Turkey.

- *When parent companies are suspected to be distressed, some EU host supervisory authorities have enforced a stricter ring-fencing regime.*[75, 76]

- *Many EU hosts still prefer that their subsidiaries draft their own individual or sub-consolidated recovery plans.*[77] *Some host authorities require the mandatory inclusion of potential support from the parent company in the individual recovery plan of the subsidiary.*

- *Host authorities may require mediation (binding or non-binding) by the EBA, especially with respect to joint decisions. EBA´s non-binding mediation has included joint decisions, liquidity, recovery planning, and supervisory measures.*[78] *Home authorities have also demanded the non-binding mediation by the EBA for ring-fencing measures adopted by EU hosts. EBA´s binding mediation is seen only as a last resort and has been recently called on by some EU resolution authorities when agreeing on resolution planning, resolvability assessments and MREL requirements.*

However, these powers are generally not available to EU host authorities of branches. As a result, many EU host supervisors remain opposed to branching, especially if the foreign bank wants to raise retail deposits in the host country.[79] This is despite CRD IV's requirements for home supervisors to share information[80] and for a mechanism to determine a branch as significant (article 51) resulting in more information being shared with the host supervisor and the host's membership in resolution colleges[81]. Moreover, a branch can be designated as a "significant-plus branch" and made subject to strengthened supervisory procedures and even more intense home-host coordination.

5.3. Non-EU host countries (EU candidates and non EU candidates)

The following discussion focuses specifically on small non-EU host countries in CESEE. These countries can be divided into two different groups EU candidate (including potential candidates) and non-candidate countries. Naturally, the former has significantly stronger incentives to align with EU regulations and supervisory practices. However, it is important to stress that the candidate status only affects the host, not the home supervisor, as from the perspective of the EU both candidate and non-candidate countries are considered third country.

As a result, for participation in EU supervisory and resolution colleges, all non-EU countries are third countries, regardless of their candidate status. At the request of a third country authority, the EU home authority may invite it as an observer to the supervisory and resolution colleges.[82] Such participation offers benefits for host country supervisory and resolution authorities (Box 7). In this respect, both EU regulations and EBA and other EU bodies encourage EU home supervisors and resolution authorities to closely cooperate with non-EU European host supervisors[83], on a bilateral basis (information sharing) but especially within supervisory colleges.

[75] These regimes may entail different sets of measures such as restricted and/or subject to authorization upstream transactions between the subsidiary and the parent company, involving the payments of dividends, intra-group lending agreements, derivative contracts.

[76] More clarity on crisis preparedness and contingency planning within the supervisory colleges may help to avoid these measures if a crisis situation of the parent company or the group as a whole arises.

[77] Notwithstanding that most group recovery plans already include the information (on the recovery indicators and recovery measures, among others) related to the subsidiary or subgroup under supervision of the host supervisory authority.

[78] See 2016 EBA Annual Report

[79] The migration to a single deposit guarantee scheme would not apply in this case, so deposits raised through branches in host countries would be insured by the deposit guarantee scheme of the home country, creating risks and unbalances in the process.

[80] See Article 50 of CRD IV.

[81] Article 51(3) even includes the obligation of set up resolution colleges made up only by the consolidating supervisor and the host supervisors of significant branches, when there are no other members of the college according to article 116 of the CRD IV.

[82] See Articles 88 (3) BRRD and 51 of CRD IV.

[83] See, for example, the priorities for 2018 EU supervisory colleges as contained in the EBA Report of the Functioning of Supervisory Colleges in 2017. It contains as main tasks for 2018 supervisory colleges "considering expanding the list of authorities with observer status in the light of the outcome of EBA´s work on equivalence provisions of non-EU supervisory authorities, following the process envisaged in the Level 1 and Level 2 provisions".

Box 7: Benefits for non-EU hosts from participation in resolution and supervisory colleges

BENEFITS FOR NON-EU HOSTS FROM PARTICIPATION IN RESOLUTION AND SUPERVISORY COLLEGES

For non-EU European supervisors, it is essential to participate in discussions within the supervisory and resolution colleges to mitigate the problems of asymmetric information between home and host authorities. **Many benefits can be identified for hosts from their participation in these colleges:**

- **First, within the colleges the information shared by the home supervisor or the group-level resolution authority and the rest of the participants enables the non-EU hosts to improve their understanding of the whole group and the position of the subsidiary in the group**. For example, in the supervisory colleges it is expected that the home supervisor shares (at least annually) the mapping of the group, the supervisory examination program, the group risk assessment (including liquidity risk assessment) according to SREP standards, and the group recovery plan. The consolidating supervisor may also share other information, like ICAAP and ILAAP reports.

- **Host supervisors are grappling with many new EU regulations and guidelines. The supervisory and resolution colleges are a forum for sharing experience on implementation.** For example, college discussions on group risk assessments or group recovery plans expose practical expertise and knowledge on how to apply these new and complex requirements. This is even more important when dealing with institution-specific capital and liquidity requirements. Even though Pillar 2 add-ons have been available for supervisors for a long time, few non-EU supervisors have used them as they generally have higher Pillar 1 requirements. Discussions in the supervisory colleges are the ideal places for understanding different supervisory practices, especially for Pillar 2 capital requirements and Pillar 2 guidance. The same applies for supervisory stress tests, ICAAP and ILAAP assessments and the assessment of SREP elements like the viability and sustainability of business model, and what to expect from risk appetite frameworks.

- **Finally, supervisory and resolution colleges may contribute to the building of trust between authorities, a precondition but no guarantee that cooperation will occur in a crisis. In this respect**, while the EU regulations require colleges to hold at least one physical meeting a year; experience[84] shows that most supervisory colleges meet physically at least twice a year.[85]

That said, before a third-country host supervisor can join the supervisory college with observer status the following requirements apply:

- *There is a regulated procedure to be followed before a non-EU authority can gain observer status.[86] The consolidating supervisor should first notify the other members of the college of its intention to invite the non-EU host authority. To participate in the college, the other members must not oppose this proposal.*

- *Before becoming an observer, the consolidating supervisor needs to assess the equivalence of the confidentiality and professional secrecy requirements applicable to the third country supervisory authority (Table 11), a process usually facilitated by the EBA.[87]*

- *The non-EU host supervisory authority should sign the written cooperation and coordination agreement in accordance with the applicable minimum requirements as outlined by the EU regulations.*

Observer status does not always have the same scope and content since the home supervisor is responsible for proposing the scope of observers' rights to access information. Non-EU small host supervisors can be classified into two categories when it comes to participation in supervisory colleges.

[84] Experience on the operation of supervisory colleges shows that the consolidated supervisory authority is unlikely to challenge the capital and/or liquidity levels required of the bank on an individual and consolidated basis while host supervisors are also unlikely to challenge the consolidated capital and liquidity requirements of the banking group, as proposed by the home supervisory authority.

[85] See the case of Poland. Through the listing of the subsidiary, the autonomy and independence of the subsidiary with regard to the rest of the group may increase naturally due to corporate governance and disclosure requirements that are applicable to listed companies. A situation where some foreign-owned banks also have minority shareholders and are listed in the stock market also happens, like Turkey.

[86] See Commission Implementing Regulation (EU) 2016/99 of 16 October 2015, laying down implementing technical standards with regard to determining the operational functioning of the colleges of supervisors according to Directive 2013/36/EU of the European Parliament and the Council.

[87] The EBA has made its own assessments and has concluded that some non-EU European countries (Bosnia Herzegovina, North Macedonia, Montenegro, Kosovo, Serbia, and Turkey) have an equivalent regime in terms of confidentiality. In any case, the opinion on the equivalence of the confidentiality provisions shall be made by the consolidating supervisor.

In the first category are the many supervisory colleges where third-country supervisors still do not have observer status. In the other category, supervisors participate as observers in the general college where they can access relevant group information and participate in the risk assessment of the group, but do not participate in joint decisions. Non-EU hosts have been increasingly invited to supervisory colleges organized by the SSM.[88] For this purpose, the ECB has been signing cooperation agreements with other authorities, and in addition it has assumed the bilateral agreements that national authorities had signed in the past.

Table 11: EBA professional secrecy and confidentiality regime applicable to each third-country supervisory authority

State / Agency	Competent authority	Overall assessment	Date
Albania	Bank of Albania	Equivalent	11/09/2015
Australia	Australian Prudential Regulation Authority Reserve Bank of Australia	Equivalent	11/07/2017
Bosnia-Herzegovina	Banking Agency of Republika Srpska	Equivalent	02/04/2015
	Banking Agency of the Federation of BiH	Equivalent	
Brazil	Central Bank of Brazil	Equivalent	02/04/2015
Canada	Office of the Super-intendent of Financial Institutions	Equivalent	02/04/2015
China	China Banking Regulatory Commission	Equivalent	02/04/2015
Bailiwick of Guernsey	Guernsey Financial Services Commission	Equivalent	20/06/18
Hong Kong	Hong Kong Monetary Authority	Equivalent	11/07/2017
Japan	Bank of Japan Japan Financial Services Agency	Equivalent	11/07/2017
Korea	The Bank of Korea	Equivalent	20/06/18
Kosovo	Central Bank of the Republic of Kosovo	Equivalent	11/07/2017
Macedonia	National Bank of the Republic of North Macedonia	Equivalent	02/04/2015
Mexico	Bank of Mexico	Equivalent	02/04/2015
	National Banking and Securities Commission	Equivalent	02/04/2015
Montenegro	Central Bank of Montenegro	Equivalent	02/04/2015
Serbia	National Bank of Serbia	Equivalent	02/04/2015
Singapore	Monetary Authority of Singapore	Equivalent	02/04/2015
Switzerland	Swiss Financial Market Supervisory Authority FINMA	Equivalent	02/04/2015
Turkey	Banking Regulation and Supervisory Agency	Equivalent	02/04/2015
Uruguay	The Superintendence of the Financial Services of the Central Bank of Uruguay	Equivalent	20/06/18
USA	Federal Deposit Insurance Corporation	Equivalent	02/04/2015
	Office of the Comptroller of the Currency	Equivalent	
	Board of Governors of the Federal Reserve System	Equivalent	

Equivalence assessments for supervision are no guarantee for being granted observer status in resolution colleges. While the BRRD strongly encourages cooperation and coordination with non-EU authorities, the participation of non-EU countries in resolution colleges has been so far limited. The rather less developed and efficient resolution frameworks in these countries must be considered though. Like the process for supervisory colleges, third country Resolution Authorities may, at their request, be invited to participate in the resolution colleges as "observers" upon the following conditions:

- *Subject to equivalent confidentiality requirements (as assessed by the group level resolution authority i.e. the SRB);*
- *Invitation after group level resolution authority agreement, following consultation with the college members;*
- *Only when the third-country entity is a subsidiary, or a branch that is significant if it were located in the EU.*

[88] According to the 2017 SSM Annual Report, the ECB had, until December 2017, joined existent MoUs of Eurozone National Competent Authorities with 9 EU non-Eurozone EU Member States and 45 with third-country supervisory authorities. Moreover, the ECB has signed MoUs with 25 supervisory authorities since its inception

If the application is accepted by the College, the non-EU resolution authority may become an "observer" and thus becomes eligible to receive and share information for resolution planning purposes. It will not be able to participate in the joint decisions of the college and will usually not receive the group resolution plan, but will receive presentations and background material like CMGs. In addition, and before getting observer status, bilateral cooperation agreements are concluded.

5.3.1. Banking regulation and supervision in candidate countries

EU candidate host countries, and those that have publicly stated that they seek to join the EU, have implemented or are in the process of implementing regulations and supervision practices based on the EU regulatory and supervisory framework. For example, many have signed written cooperation and coordination agreements and have also participated in supervisory colleges as observers. This process is essential for these authorities for a variety of reasons, from political (convergence is required to advance in the EU accession talks) to prudential (see Box 8).[89]

For example, a major step forward has been the signing of the Memorandum of Cooperation between the EBA and six Balkan countries.[90] These commit signatory supervisory authorities to, among other things, take steps to adjust their regulatory and supervisory standards, as well as institutional arrangements, to those existing in the EU in a manner and timeframe that are appropriate considering the specifics of each market. The adoption of the EU regulations and supervisory frameworks facilitate cooperation between host non-EU authorities and home EU consolidating supervisors. This helps ensure that both authorities "speak the same language". For example, they have developed common methodologies to perform risk assessments, making the host individual risk assessment consistent to the ones presented in the supervisory college.

Box 8: Regulatory convergence in EU-candidate countries in bank supervision and resolution

REGULATORY CONVERGENCE IN EU-CANDIDATE COUNTRIES IN BANK SUPERVISION AND RESOLUTION

Many of the non-EU hosts have implemented or are in the process of implementing EU-based regulations. These standards are based on the ones approved by the Basel Committee on Banking Supervision and cover the following areas:

- CRR-like capital requirements for credit, market and operational risk, including requirements for capital buffers and leverage ratio. But some differences with EU regulations usually persist. For example, some non-EU host countries have implemented stricter minimum Pillar 1 capital ratios across the board, higher standardized risk-weights for certain portfolios (i.e. residential mortgages), and have not granted the possibility to calculate capital requirements based on internal models (as in Basel II and Basel III).[91]

- LCR liquidity requirements have replaced or complemented progressively the local liquidity and funding standards which were in force in many of these countries.

- Minimum governance standards on EU rules, regarding remuneration, internal control, role of the board of directors, etc.

[89] As explained above, in some jurisdictions most of the systemically important banks are integrated in EU banking groups..

[90] The Banking Agency of the Federation of Bosnia and Herzegovina, the Banking Agency of the Republika Srpska, the National Bank of the Republic of North Macedonia, the Central Bank of Montenegro, the National Bank of Serbia, and the Bank of Albania

[91] The reluctance to allow capital requirements based on internal models is often explained by a number of reasons including: to avoid complexity and due to lack of resources in the supervisory authority to perform model validation, small credit portfolios in the country do not justify the development of internal credit models to calculate capital requirements, to avoid competitive disadvantages for local banks that do not have the capacity to develop these models against foreign-owned entities, and some distrust in a regulation based on internal models.

- **Supervisory information** based on EU standards.[92]

- **Risk management standards** close to EU ones, including, among others, requirements to develop ICAAP and, in some cases, ILAAP reports.

- **Supervisory powers** to require institution-specific capital, liquidity, and other Pillar 2 measures to be applicable to banks.

- EU-based requirements for banks to draft **group recovery plans**.

- **Crisis management measures**, including the ability of the supervisor to take early intervention measures.

- In addition, many of these authorities are also adapting their processes to make them converge to EU standards, as defined by the EBA and (complementary) by other supervisors, including amending their supervisory assessment systems[93] to ones based on SREP, as defined by the EBA Guidelines and devoting more time and resources to review documents and processes that are essential in the new EU supervisory framework, like ICAAP, ILAAP, recovery planning or risk appetite framework.

Regulatory convergence with the EU framework is also taking place in bank resolution

- **Many candidate countries have set-up new functionally independent resolution departments regularly within existing supervisory authorities along the lines of the BRRD. Some important divergences from simple BRRD take over relate to resolution funding, phasing in of Bail-in and MREL or the special treatment of "affiliated parties" exempting them from the pari passu principle.**

- **Drafting of resolution plans, resolvability analysis to identify ex-ante potential obstacles to the resolution of the banks as well as imposition of MREL requirements still most authorities have not yet started to prepare.**

- **Also, the starting point for introducing a special bank resolution regime, is quite different from most EU countries in many FinSAC client countries as most already had** an administrative based liquidation process allowing for P&A and Bridge Banks.

5.3.2. Potential issues faced by host authorities in candidate countries

Even though candidate country host authorities are making important progress towards the implementation of regulatory and supervisory frameworks aligned with the EU, it is likely they will require more stringent capital and liquidity requirements if the coordination and cooperation with home authorities is not satisfactory. Some common problems faced by host supervisors when dealing with EU home supervisors include:

a) *Non-EU host countries must implement the European rulebook before they can qualify as candidates. EU regulations are complex and comprehensive, and the transition from old regimes (usually based on modified versions of Basel I and with limited regulations on resolution) is difficult. In many cases, the local authorities must digest and understand the European regulations first, and then assess if the EU rules are relevant to their financial systems. In many instances, the EU rulebook is not necessarily well adapted to the relatively small and non-complex financial systems heavily based on banking intermediation[94]. Technical assistance providers can help with the interpretation and tailoring of EU regulations to the country specific environment.*

[92] Supervisory reporting information and on own funds and other prudential rules.

[93] Some of these countries have had other supervisory assessment methodologies; some of them based on the US CAMELS rating system.

[94] Such as MREL, remuneration, and internal approaches for the trading book capital requirements.

b) *Many non-EU hosts do not participate in the EU Supervisory Colleges, particularly those organized by the SSM. This may create or increase the information asymmetries between home and host supervisory authorities. As part of informal feedback sought from host supervisors in FinSAC client countries, some non-EU supervisors replied that the attention paid by the home supervisor has decreased since the establishment of the SSM. They believe that the colleges currently organized by Eurozone national supervisory authorities have a higher engagement level with non-EU hosts than the colleges organized directly by the SSM for significant institutions. It may well be that this observation proves to be temporary, as the SSM is a relatively new institution and will need time to develop its engagement with host supervisors.*

c) *Participation in supervisory colleges remains much more widespread than in resolution colleges. This may be explained by several reasons. First, the resolution authorities are generally young institutions, mainly created after the national implementation of BRRD. The SRB was only established in 2015. Hence, they have been focusing on organizational, logistical, and technical issues since most activities they conduct (resolution planning, MREL, etc.) were completely new. Even though CMGs for global systemically important institutions have been organized since 2011, resolution colleges have been less relevant for small country hosts so far. For many of the issues discussed in the European resolution colleges a policy has yet to be developed and discussed. Moreover, the confidentiality and professional secrecy regime assessment as "EU-equivalent" a requirement to become observer is a very demanding and work intensive process for EU authorities, especially for the SRB, given its workload and recent establishment. In addition, the EBA has not (yet) issued any non-binding equivalence assessment for resolution, unlike for supervision (see above). These EBA assessments shall be employed as a basis for the assessments by the different resolution authorities across the EU. Most host countries have only recently passed laws detailing their special resolution regimes and their operationalization is at a relatively early stage of development. In many cases the resolution authorities are still in the process of staffing and deciding on their organizational set-up. They have yet to prepare resolution plans or resolvability assessments, and hence cannot contribute to the development of the European colleges. The group level resolution authority should nevertheless ask these authorities to join at this early stage – acknowledging that formal request has to come from the host authorities- to start establishing relationships, building trust, and expanding good practices that can further harmonize resolution planning.*

The next few years will be very challenging for both EU and non-EU resolution authorities. They must finish the institutional set-up, decide on policy issues such as MREL, draft first or new versions of resolution plans and resolvability assessments, and enforce requirements for banks (including measures to remove obstacles to resolution). Though not legally obliged like EU hosts, small non-EU hosts might want to determine, jointly with the EU home resolution authority, if the subsidiary constitutes a separate point of entry in a MPE context or is included in a SPE banking group. If non-EU subsidiaries were to be considered as separate points of entry, the subsidiaries need to be separable from the rest of the group to ensure (i) the parent entity can enter resolution without the need for the subsidiary to be resolved, and (ii) if the subsidiary is resolved, the parent entity can continue to perform as a going concern because it has decided not to save the subsidiary (see Box 9). Small host authorities will prefer ensuring enough loss absorbing capacity (internal LAC) is available in case of need, regardless of whether the overall group resolution approach is SPE or MPE.

If significant disagreements between home and host authorities arise, the EU conflict-solving mechanisms are not available to non-EU hosts and there is no joint decision for these cases. The bargaining power of non-EU small host authorities may be rather limited in practice, especially as they may not want to challenge or formally oppose approaches decided by the centralized Eurozone supervisors if their countries are in the process of becoming members (or candidates) to the EU.

Box 9: Can parent banks let subsidiaries fail; how the new resolution framework can shape the debate

**CAN PARENT COMPANIES LET SUBSIDIARIES FAIL?
HOW THE NEW RESOLUTION FRAMEWORK CAN SHAPE THE DEBATE**

As the parent company and the subsidiary are different legal entities their interests are not always aligned, and the subsidiary of the banking group may sometimes not be rescued by the parent company.

However, in practice parent companies normally have a clear interest in bailing out their subsidiaries:

- In many cases, not bailing them out is simply impossible. In many banking groups, the parent companies guarantee the liabilities of their subsidiaries through financial guarantees, or comfort letters. This is usually the case for centralized banking groups where decisions are made at parent level and the subsidiary is just a conduit for business in the host country. These subsidiaries may be, in some cases, very close in nature to branches. Consequently, the performance of these groups is so correlated that the subsidiaries cannot fail without the parent company failing, and vice versa.

- However, there may be cases where the links between the subsidiary and the parent company are not so close and the parent company must decide if it supports the subsidiary. **In most cases the parent company will decide to grant support (in the form of capital or liquidity or both) to the subsidiary for the following reasons:**

    - Financial interest: Often not letting the subsidiary fail is in the financial interest of the parent, since the new investment made by the parent would serve to clean up the balance sheet and give a new start. There are many examples of banks recapitalizing their subsidiaries following losses.

    - Potential liability: If the decisions made by the management of the subsidiary (which in turn reports to the management of the banking group) is responsible for the bank failing, the parent company may be deemed responsible for the losses. If the liability risk is relevant, the parent bank would decide to support the subsidiary. HSBC, for example, was effectively banned from walking away from its US subsidiary Household Finance.

    - Reputational risk: Even when the bank failure is not linked to decisions of the parent entity (for example, in the case of a macroeconomic or systemic crisis in the host country), the expectation of the host authority will be that the parent entity should cover losses if they arise. Particularly in the case of cross-border banking groups with a presence in different host countries, any signs of not supporting the subsidiary in one country may prompt other host supervisors to ring-fence the subsidiaries in their country.

    - Host country: Some countries explicitly state their expectation that the subsidiaries should be supported by parent entities. In the US, for example, the "source of strength" doctrine has been the main rule, and it has been recently complemented with the requirements for foreign banks to set up separate capitalized and governed intermediate holding companies.

**Nevertheless, there are cases where parent entities decided not to support their subsidiaries.
They can be divided into two different groups:**

- The parent entity or group is in distress. In some situations, the whole group may be insolvent and the parent company may not have placed enough loss-absorbing resources in the subsidiary. In these situations, the losses cannot be up-streamed to the parent entity. See, for example, the European subsidiaries of Lehman Brothers.

- There is no financial interest in supporting it. The parent entity decides to not support the subsidiary, because it considers that the failure cannot be attributed to its management of the subsidiary. In these very rare cases, the subsidiary may fail or be bailed out by the host country´s public sector. See the cases of Citibank or Credit Agricole during the Argentinian crisis or, more recently (to a more limited extent) the case of the Greek subsidiary of Credit Agricole (Emporiki).

For group loss absorbing approaches under SPE/MPE resolution strategies see above 4.2.

Many non-EU resolution authorities have already implemented MREL legislation and are in the process of implementing MREL calibration for individual banks. MREL requirements are mostly based on the EU approach, under which the group's consolidated MREL also includes the exposures that the group has through its third-country subsidiaries and branches. When setting MREL, several scenarios have to be considered from a third country small host perspective.

If, in case of non-viability, the resolution plan of a bank foresees that the bank enters resolution proceedings, then the MREL should be calibrated considering the capital requirements the resolved bank will face after resolution is enforced. For banks expected to be resolved under bail-in preferred resolution strategies, it may well mean that the bank should hold roughly twice its minimum capital requirements to comply with MREL requirements. Requiring MREL as high as twice the capital requirements can be challenging, however, and might have unintended consequences, particularly considering shallow private debt markets and common higher local capital requirements across the region.[95] Parent companies may have to increase their investments in the subsidiaries significantly without increasing the local assets, effectively reducing their returns.

However, considering the flexibility that EU-based MREL requirements provide and the specific features of non-EU banking systems, resolution authorities consider different aspects of the resolution strategy when defining institution-specific MREL requirements. They may consider sale of business[96] or other partial transfer resolution strategies which would trigger lesser MREL instead of bail-in, although this resolution strategy has also its own limitations in small countries.

In most accession countries that have aligned their framework with the BRRD, it is not defined in which form MREL instruments have to be provided for i.e. capital or debt instruments. It has also not been specified if MREL would always need to be 'pre-positioned' on the balance sheet of the entity in the form of a fully paid up instrument or not. Prepositioning will give highest legal certainty to host countries to bail-in the instrument when needed. That said, fully, paid-up instruments might expand banks' balance sheets with potentially negative consequences on performance and increased investment risks. In case collateralized guarantees are allowed under certain specified circumstances (under internal MREL approaches) considering SPE and MPE structures, authorities should pay attention to ensure collateral is executable in a timely manner i.e. not governed by foreign country law.

The strengthening of prudential standards across the banking system reduces the probability of bank failures but there is a cost, especially for small jurisdictions with limited business opportunities. Banks will argue that raising the levels of capital and liquidity or restricting the exposures of the subsidiary reduces the attractiveness of the local financial sector to foreign direct investment. Some EU parent entities have been selling their subsidiaries in many non-EU countries to focus on their domestic banking markets or on a more limited number of markets. The number of western European banking groups interested in engaging in some banking markets has decreased, significantly in some cases. Raising the capital requirements of the local subsidiaries (for example, through a strict implementation of the MREL requirements) may prompt some parent entities to reassess their presence in the local market.[97] A balance should be struck between host authorities' objective of financial stability by ensuring legal certainty, and comfort that the subsidiary can be resolved even without parental support and the effects of (internal) MREL on the returns from a group perspective.

[95] Capital requirements are often higher in non-EU countries than in the EU. This is for several reasons. First, it is not unusual for minimum Pillar 1 capital requirements to be as high as 12%; and for newly implemented capital buffers and Pillar 2 requirements to be required on top of this 12%, without any transitional period. Second, risk-weights are usually higher in non-EU countries since there is rarely the option to use internal models for calculating risk-weights and standardized risk-weights are normally higher for certain portfolios (e.g. residential mortgage portfolios). Finally, capital requirements act as a buffer for weaker data quality and granularity and capacity in supervision in some countries.

[96] If the sale of business is the main resolution strategy, the resolved bank will be expected to be sold to a third-party buyer when resolved. In this sense, it can be argued that the provision of the fresh capital required to recapitalize the bank would be provided by the buyer, so there may be no need for MREL to consider the recapitalization amount. And the credibility of the application of this strategy in many of these countries is frequently high because of the abundance of potential buyers with capacity (capital and liquidity) and interest in a potential takeover of the resolved bank. This is explained by the fact that many of the potential buyers may be large foreign groups already operating in the country. To these buyers, the absorption of the bank will not be challenging due to the small size of these subsidiaries in relation to the whole-group balance sheet.

[97] These reassessments may consist of portfolio restructurings (e.g. reducing high risk-weight exposures for lower risk-weight ones), significant downsizing of their activities in the country, or even the outright selling of the full operation.

Like the small EU hosts, the home supervisor may decide to enforce stricter limits on sovereign holdings of debt issued by non-EU hosts or to divest in certain non-EU NPLs to which the banks are exposed through their subsidiaries. These decisions (taken on a consolidated level by EU supervisors) may impact local financial systems, triggering the sale of NPLs or locally-issued sovereign bonds and impacting the credit conditions in the host country (Box 10).

Box 10: Sovereign bond holdings in non-EU countries

SOVEREIGN BOND HOLDINGS IN NON-EU COUNTRIES

CRD Article 114 states that government bonds of non-EU states attract a non-zero risk weight unless (i) their risk is rated not lower than AA-/Aa3 or (ii) supervisory and regulatory arrangements are considered equivalent to those applied in the EU. If the second condition is satisfied, the risk weights as applied by the host country for their bonds in local currency are accepted in the EU.

This requirement creates a divergence between the consolidated and the solo capital calculations. In accordance with the Basel regime, the non-EU host subsidiary applies a zero risk weight to sovereign bonds. The risk weight applied by the EU-based parent bank for the consolidated capital calculation will generally be higher, unless the host country's supervisory and regulatory regime has been deemed equivalent to the EU or the host country sovereign has a high credit rating. Non-EU host countries argue that this divergence can have negative repercussions for the development of government bond markets in their country, especially where foreign banks dominate the banking system. Further, it can complicate the definition of high-quality assets for the LCR and ultimately undermine access to liquid assets.

5.3.3. Bank regulation, supervision, and resolution in non-candidate countries

Unlike EU candidate or accession countries, non-candidate countries have no incentive to adopt the EU regulatory and supervisory framework, but rather have the freedom to focus on the most immediate needs in upgrading their financial safety net. While most of these countries aim to adopt Basel II and III, they can, and should, be more selective in implementing reforms.

Unlike EU-hosts, non-EU hosts can take unrestricted actions regarding a foreign-owned subsidiary, to effectively ring-fence it from the rest of the group, as they are not bound by the EU rulebook. They may take several measures, including:

- *Increase the capital requirements that are applicable to that subsidiary, making use of Pillar 1 and Pillar 2 requirements. Some host supervisors have already taken these measures to strengthen capital buffers and thus strengthen the subsidiaries under their supervision from the problems in their parent entities.*

- *Restrict the dividend policy of the subsidiary, forcing the subsidiary to apply a specific profit retention policy, especially if it is expected that the parent company would not be able to support the subsidiary when needed.*

- *Restrict the liquidity and funding exposures from the subsidiary to other members of the group—the most frequently used restriction is to impose large exposure limits to the group (usually more stringent that the 25% limit over own funds that the BCBS recommends).*

- *Reinforce the governance requirements of the subsidiary, asking for a specific policy on intra-group transactions or increasing the number of independent directors in the subsidiary´s board.*

Most non-candidate countries in the region face significant challenges with effective bank supervision because of limited resources. A bank resolution framework might or might not exist, and the institutional foundations to implement different resolution approaches are often missing. The BRRD resolution tools may not be feasible in non-candidate countries, with the practical approach mostly likely being a purchase and assumption operation and possibly a bridge bank operation. The main challenge for the first is the choice of acquiring bank and the implications for the market. The biggest challenge for a bridge bank is the limited capacity in most countries to run such an operation and the risk that it will last longer than expected. Discussions on MREL are premature in this context as bail-in is very difficult, if not impossible, because there are few non-deposit liabilities and debt markets yet to be developed. This situation is the same in many other developing countries across the globe.

Experiences from other regions, such as Central America and Africa (Beck et al., 2014) have pointed to the importance of focusing on effective bank supervision (as gauged by, e.g., the Basel Core Principles of Effective Supervision), especially the principles related to cross-border supervisory information exchange, coordination, and cooperation. It also points to the important effect that cooperation among host countries with similar levels of supervisory capacity can have in terms of learning effects, and in terms of a stronger voice of host countries vis-à-vis home supervisors. It also remains important to continue to develop strong supervisory frameworks and skills to ensure the "ability" and the "will" to act early and effectively. This requires appropriate resources, authority, a clear and unambiguous mandate, operational independence and accountability, and constructive working relationships with the home supervisor. Nevertheless, without a credible threat of resolution, prudential supervision remains hard to enforce.

6. Conclusions

This section provides some conclusions of our analysis, which can also serve as recommendations for different authorities.

1) *Non-EU hosts should participate in EU resolution colleges and CMGs.*

   The participation of non-EU hosts in EU resolution colleges and CMGs as observers should be encouraged. The EBA can facilitate this process by issuing non-binding opinions concerning the assessment of confidentiality and professional secrecy regimes of non-EU hosts. Like supervision, EU group-level resolution authorities could use EBA assessments as a starting point to conduct their own. The EBA can also issue a non-binding recommendation to EU authorities by which the non-EU resolution authorities of systemic subsidiaries of candidate countries should be conferred preferential status for becoming observers within the EU resolution colleges[98]. European consolidating authorities, especially the ECB and SRB, can also take direct initiatives and invite non-EU supervisors / resolution authorities of systemic subsidiaries and branches to the EU colleges.

2) *Non-EU hosts should be given observer status in EU supervisory and resolution colleges*

   It is important to expand the active participation of non-EU hosts in EU supervisory and resolution colleges as observers (preferential status) and ensure the same treatment among all host (candidate) countries. This can be facilitated by the EBA issuing a non-binding recommendation to EU authorities on the treatment of observers ie as regards access to documents, provide a platform for sharing of common concerns.

3) *EU authorities should improve cooperation with non-EU hosts and consider how decisions will impact them*

   It would be helpful for EU authorities to be more transparent and reflect more on the impact of their decisions on hosts' financial systems. This is especially relevant for the impact of SSM and SRM on non-EU hosts, since the latter do not benefit either from participation as members of the EU colleges or from the joint decision processes under EU regulations. Communication and cooperation with small hosts before

[98] Currently candidate countries that have a significant percentage of their banking system owned by EU banks, are grouped together with other third countries.

making decisions, including on reducing NPL levels and exposure of sovereign bonds, would be desirable. It is also critical that EU consolidating supervisors, and particularly the SSM, consider the effects on small hosts when authorizing cross-border M&A transactions between EU banking groups to thus avoid further concentration in these markets. Additionally, more transparency in defining the main criteria for selecting the resolution approach for EU banking groups – SPE or MPE – would also be helpful for host resolution authorities, including being open about the consequences of identifying a subsidiary as a separate point of entry and their approach to internal MREL (for SPE groups).

4) *Small EU host countries should make use of the EBA mediation service when relevant*

   Small EU host countries outside the banking union should consider using the mediation services of the EBA strategically to ensure their interests are properly protected when it comes to joint decision making in colleges.

5) *Non-EU host candidate countries should adapt EU regulations to fit their national circumstances*

   Non-EU host candidate countries shall, to the extent possible, adapt EU regulations to the features of their local financial systems rather than adopting them blindly. A regional forum for cooperation in banking supervision and resolution, or further expanding and focusing existing structures[99], would be an important step towards sharing common experience with EU authorities in supervision and resolution and representing joint interests of small host countries (see Box 11).

6) *Non-candidate countries can be flexible in adopting the most appropriate elements from international frameworks*

   Non-candidate countries in the region would benefit most from a more flexible approach to adopting Basel III and EU rules, focusing on fundamental upgrades to their financial safety net, including bank resolution. Participating in regional structures as discussed for candidate countries can be as, if not even more, helpful for these countries.

Box 11: Steps for effective cross-border supervision in Central America

STEPS FOR EFFECTIVE CROSS-BORDER SUPERVISION IN CENTRAL AMERICA

The rise in international and regional banking groups and related cross-border supervision and resolution challenges for host countries are not confined to ECA. Central America has also experienced a significant (and in some cases a dominant) foreign/regional bank presence even prior to the global financial crisis. Expansion of cross-border banking resumed soon after the crisis eased. Among 12 principal banking groups operating in the region in 2010, half were supervised by authorities in Panama and Colombia, and about a third were supervised by authorities in Guatemala and Dominican Republic. There have also been instances of withdrawal of banks from advanced countries—for example, Davivienda (Colombia) took over HSBC's investments in Costa Rica, Honduras, and El Salvador in 2012. These developments put cross-border supervision challenges at the forefront of policy discussions in the region. The Central American Council of Superintendents of Banks, Insurance, and Other Financial Institutions (CCSBSO)—a forum for coordination among supervisors in the region—has since carried out several forceful initiatives to improve cross-border supervision and exchange of quality information among supervisors.

CCSBSO first assessed priorities for effective cross-border consolidated supervision and, with support from IMF's regional technical assistance center (CAPTAC-DR), prepared a "Strategic Plan" incorporating a concrete timeline of necessary steps over the 2010-2014 period. In 2011, CCSBSO established a Liaison Committee (with representatives from all member countries) to meet bi-annually to identify material risks and coordinate consolidated cross-border supervision, share relevant information and concerns as much as (and as soon as) possible, request information from member countries' (home/host) supervisors. CCSBSO also put in place yearly implementation targets including for developing new methodology/procedures, pilot and final implementations, automated exchange of information (monthly/quarterly), and the establishment of a (pilot) college of supervisors.

[99] For example, the group of Banking Supervisors from Central and Eastern Europe.

In 2012, a new methodology for improving risk analysis and consolidated supervision of banking groups was developed, and a comprehensive set of reporting formats and accompanying guidelines was delivered to the supervisors in each country through workshops. By the end of that year, consistent data collection, analysis, and sharing across countries was broadly achieved. Nevertheless, some hurdles remained—for example, until recently, Panama did not supervise its bank holding companies so it could not provide information on them to other countries.

A welcome development was Colombia joining the CCSBSO in 2012, but transforming this new membership status into active collaboration has been difficult, partly as legal changes were required to allow exchange of information with the other members. In 2013, the Liaison Committee started performing tests on the implementation of the new methodology with actual data from financial groups through the newly established „College of Supervisors", and later in 2014 conducted global off-site assessments. Overall, the 2010-2014 strategic plan of the CCSBSO achieved significant advances in the implementation of consolidated cross-border supervision in the region. CAPTAC-DR provided substantial support to CCSBSO during this process through comprehensive policy advice, technical assistance, and training.

Further progress will continue to be needed, however. The CCSBSO's Strategic Plan for 2015-2019 focuses on defining and implementing action plans (again with support from CAPTAC-DR) to (i) close the regulatory and supervisory gaps in cross-border supervision and (ii) require financial groups to manage liquidity and solvency at a consolidated level and to manage risks to regional groups. Moving towards fully effective cross-border supervision remains challenging for the region, but not impossible given the strength of the reforms proposed and the CCSBSO's commitment (and track record) to implement them.

Annex

Joint Decisions

- ***Institution-specific capital requirements;*** *the consolidating supervisor and the rest of EU competent authorities shall agree on the level of Pillar 2 capital to be required on a consolidated basis and on an individual or sub-consolidated basis for each institution within the group.*[100] *The authorities have a 4-month period to reach a common decision after the consolidating supervisor submits a group risk assessment report to the other authorities. In the absence of a joint decision, the consolidating supervisor will decide on the consolidated level, where the host authorities will decide on the individual or sub-consolidated levels of capital. Nevertheless, within the 4-month period, either the home supervisor or the host authorities may refer the decision to the EBA, which will exert its binding mediation.*[101] *These joint decisions are becoming the most important piece of home-host coordination and cooperation in the EU.*

- ***Institution-specific liquidity requirements.*** *The home supervisor and the rest of the EU competent authorities shall agree on the liquidity levels to be held by both the group on a consolidated level and by each of the institutions on an individual or sub-consolidated level.*[102] *The authorities have a one-month period to reach a common decision after the consolidating supervisor submits a report on the liquidity risk assessment of the group to the other participant authorities. In the absence of a joint decision, the home supervisor will decide on the consolidated level, where the host authorities will decide on the individual or sub-consolidated levels of capital. Within the one-month period, the consolidating supervisor or the host authorities may refer the decision to the EBA, which will exert its binding mediation. Although much less material (as not directly affecting leverage and shareholders' returns) than the joint decision on capital, this one-month deadline to come to an agreement is expected to gain relevance in the future.*

[100] See Article 113 of CRD IV and Commission Implementing Regulation No 710/2014 of 23 June 2014 laying down implementing technical standards with regard to conditions of application of the joint decision process for institution-specific prudential requirements according to Directive 2013/36/EU of the European Parliament and the Council.

[101] See Article 19(3) of Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC

[102] See Article 113 of CRD IV and Commission Implementing Regulation No 710/2014.

- ***Validation of internal models and approving significant changes in them,***[103] *through a Joint Decision on internal models on credit risk, counterparty credit risk, market risk, and operational risk. The authorities have a 6-month period to reach a common decision after the home supervisor receives the specific application. These 6-month processes are very relevant for supervisory colleges and especially for home supervisors because if the authorities fail to reach a joint decision the home supervisor may decide unilaterally to allow the use of internal models for consolidated supervision purposes, not on a solo basis. However, either the consolidating supervisor or the host authorities may refer the decision to the EBA for a decision under binding mediation.*

- ***Assessment of the significance of a cross-border branch in the EU.*** *The competent authorities of a host Member State may request the home supervisor to consider a branch under its supervision as "significant".*[104] *The host supervisor shall make a request to the home supervisor and after this both will have two months for reaching a joint decision. If no joint decision is reached, the host supervisor shall take its own decision. This two-month process has not been very relevant until now but is likely to increase in relevance if more cross-border banking groups start using branches instead of subsidiaries.*

- ***Assessment of the group recovery plan,*** *involving an individual recovery plan and specific requirements on the group recovery plan.*[105] *The authorities shall make a common decision within a 4-month period, starting from the day the home supervisor submits the group recovery plan to the host authorities. However, the home or the host authorities may refer the decision to the EBA for a decision under binding mediation. This 4-month assessment period is gaining relevance, becoming one of the main pillars of the supervision of banking groups. Its nature as a bridge between going concern supervision and crisis management increases its usefulness as a supervisory tool.*

- ***Authorization of a group financial support agreement (GFSA)***:[106] *An ex-ante agreement between members of the group regarding the provision of liquidity or funding facilities in case of stress, subject to the compliance with some requirements. The authorities have a period of 4 months after the home supervisor submits the application to the rest of the authorities to agree on a common decision; if no decision is reached after that period, the home supervisor will decide on the authorization of the GFSA. However, the authorities may request binding mediation by the EBA advisors.*

- ***Authorization of actual group financial support (based on GFSA):***[107] *in case of triggering support under an IGFSA, supervisors should reach a joint decision on allowing or prohibiting/restricting the requested support within five days. The matter can be referred to the EBA for non-binding assistance, but the final decision lies with the supervisory authority of the liquidity-providing entity.*

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[103] See article 20(1) of CRR and Commission Implementing Regulation 2016/100, of 16 October 2015 laying down implementing technical standards specifying the joint decision process with regard to the application for certain prudential permissions pursuant to Regulation No 575/2013 of the European Parliament and of the Council.

[104] See article 51 of CRD IV. Further to the joint decision process, this article also include some non-exhaustive criteria for considering a branch as "significant". In particular; (I) a deposit market share in the host Member State higher than 2%; (ii) the likely impact of the suspension of the operations of the institution on the systemic liquidity and the payment, clearing, and settlement systems in the host Member State, and (iii) the size and importance of the branch in terms of number of clients within the Member State.

[105] See article 8(2) of BRRD.

[106] See article 20 of BRRD.

[107] See Article 25 of BRRD.

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