

## **The Path to Euro Area and Banking Union Membership: Assessing the Incentives for “Close Cooperation” and Adherence to the Exchange Rate Mechanism II**



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*Keywords: Banking Union, close cooperation, ERM II.*

*This Policy Brief Paper is based on a study that analyzes the recent European Central Bank (ECB) Governing Council announcement that both Bulgaria and Croatia were required entry to ‘close cooperation’ with their respective central banks following the fulfilment of the necessary supervisory and legislative prerequisites prior to the inclusion of their respective currencies in the Exchange Rate Mechanism II (ERM II). The move towards greater monetary integration requires appropriate banking supervision to ensure the stability of the ensuing cross-border credit flows between the respective groups of countries. Together, these two steps pave the way for Bulgaria’s and Croatia’s future participation in the euro area. It is evident from the research undertaken in this paper that there are clear benefits of close cooperation for these Member States whose domestic currencies were already linked to the euro, in view of the dominant position euro area banks have in their respective domestic markets. Those banks channel the likely strong expansion of credit that goes hand in hand with the participation in the ERM II as shown in the latest round of participation (Estonia, Lithuania, Slovenia, Latvia and Slovakia). It is more difficult for a national authority to exercise discretion in implementing ECB decisions once it is committed to the path leading to full European Monetary Union (EMU) membership. The uncertainty about the functioning and durability of the close-cooperation arrangement is largely removed.*

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**The establishment of the Monetary Union and the Banking Union in Europe greatly advanced integration among Member States, but also raised questions about how to achieve effective coordination between euro area institutions and counterparts in non-member European countries,** and how those non-members might transition towards inclusion in those unions if they chose to follow that path. This Policy Brief addresses certain aspects, focusing on the cases of Bulgaria and Croatia, countries which recently initiated close cooperation with the Banking Union and committed themselves to abide by the ERM II. More details can be found in our recent paper (Nieto and Singh, 2021).

It had always been envisaged that non-euro area countries could join the Monetary Union after a successful “probationary period” under the ERM II. However, the roadmap for Monetary Union did not shape the way non-euro area countries would join the Banking Union and enter in close cooperation in banking supervision and crisis management.

In the cases of Bulgaria and Croatia, the ECB Governing Council adopted a decision to establish close cooperation with the other relevant central banks following the fulfilment of the necessary supervisory and legislative prerequisites.<sup>3</sup> In parallel, the inclusion of their respective currencies in the ERM II was announced.<sup>4</sup> Participation in the ERM II is a precondition for as well as fulfilment of the nominal convergence criteria to join the euro, and as such it is binding and of a temporary nature. It should be noted that the currencies of Bulgaria and Croatia were already closely tied to the euro at the time of applying to the ERM II. Bulgaria had a currency board (first with the deutschmark, and subsequently with the euro after 1999) after a devastating debt and banking crisis in 1997. Croatia had a peg first with the deutschmark, and from 1999 to the euro, with a narrow band. All the countries that joined the ERM have become members of the EMU with the sole exception of Denmark, which opted out of the obligation to become a member for national political reasons.

Together, these two steps pave the way for Bulgaria’s and Croatia’s future participation in the euro area.

This is the first time a Member State’s national currency would join ERM II since the start of the EU banking union. Upon the introduction of the euro a Member State now also joins the banking union, which is irreversible and involves direct powers of the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) over its banking system. Therefore, participating in ERM II with a view to later adopting the euro also involves – for Bulgaria’s [and Croatia’s] as well as for any other Member State’s national currency that will in the future join ERM II – preparing for joining the banking union.<sup>5</sup>

**After the launch of the SSM, as an integral part of the institutional architecture of the euro, it was rational that EU policymakers would expect EU Member States when joining the ERM II to also require close**

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<sup>3</sup> ‘ECB Establishes Close Cooperation with Croatia’s Central Bank’, press release (10 July 2020) [https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200710\\_1~ead3942902.en.html](https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200710_1~ead3942902.en.html) (accessed 30 July 2020); ‘ECB Establishes Close Cooperation with Bulgaria’s Central Bank’, press release (10 July 2020) <https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200710~ae2abe1f23.en.html> (accessed 30 July 2020).

<sup>4</sup> The central parities and the standard fluctuation bands of plus or minus 15 per cent for both the Bulgarian lev and the Croatian kuna were agreed on 10 July 2020. See ECB press releases, ‘Communiqué on Bulgaria’ (20 July 2020) <https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200710~4aa5e3565a.en.html>; ‘Communiqué on Croatia’ (10 July 2020) [https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200710\\_1~88c0f764e7.en.html](https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200710_1~88c0f764e7.en.html) (accessed 10 September 2020).

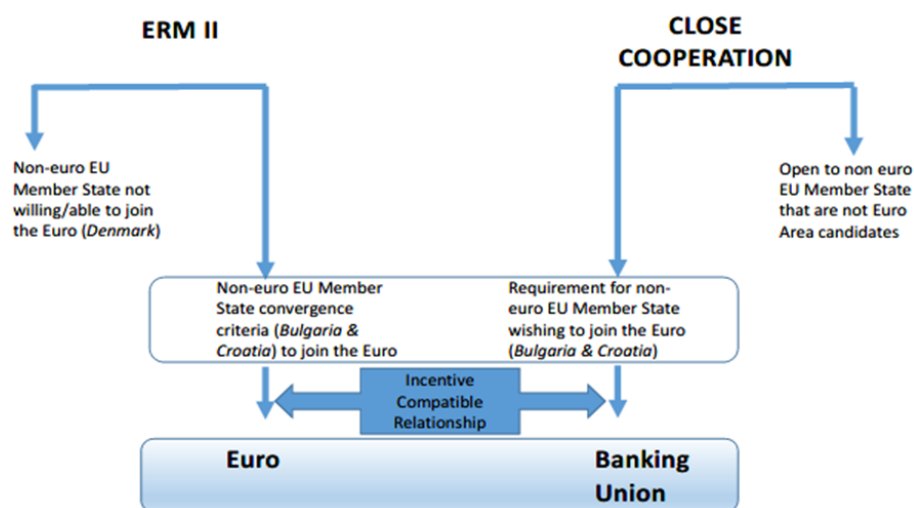
<sup>5</sup> See Annex 2, ‘Common understanding of the commitments taken by Bulgaria as participating member’ in ‘Ad-hoc Meeting of 12 July to Discuss the Prospects of Bulgaria Participating in the ERM II Mechanism’ (Brussels, 24 July 2018) <https://www.consilium.europa.eu/media/36257/summing-up-letter-ad-hoc-meeting-erm-ii-12-july-2018.pdf> (accessed 30 June 2020).

**cooperation with ECB.** The requirement for close cooperation when applying to the ERM II deals with the ‘efficiency’ gaps in the pre-existing arrangements that neglect the possibility of negative bank sovereign ‘loops’ (Nieto and Schinasi (2007), Podstawski and Velinov (2018) and Dumitrescu-Pasecinic (2019)). Against this background, as is the case for the ERM II, the ‘participation’ mechanism should be understood as a binding requirement of a temporary nature until the applying country joins the EMU.

The SSM Framework (the SSM Regulation (2013), the SSM Cooperation Framework Regulation (2014) and the 2014 ECB Close Cooperation Decision) permits non-euro-area Member States to participate in the SSM through a close-cooperation arrangement.<sup>6</sup>

In the cases of Bulgaria and Croatia, the binding and temporary nature of the close-cooperation mechanism highlights a particular case of the bespoke general governance arrangements of the SSM Framework, in which the possibility of ‘opting out’ fades with the incentives for joining the euro. The Figure below presents the options open to non-euro EU countries in terms of participation in the ERM II and/or the close-cooperation arrangement. Only simultaneous participation with a view to joining the euro is incentive compatible, as explained in this Policy Brief.

**Figure: Options open to non-euro EU countries in terms of participation in the ERM II and/or the close-cooperation arrangement**



Source: Authors’ analysis.

**The SSM framework explains how the Member States entering “close cooperation” within the SSM will have a relationship with the ECB in the SSM which is ‘comparable’ but not ‘equivalent’ to Member States of the euro area** (Singh, 2020). The SSM framework confers on the ECB the right to instruct the national authorities rather than directly supervise their significant banks. Domestic legislation in the Member States, entering into

<sup>6</sup>The SSM was established by Council Regulation (EU) 1024/2013 of 15 October 2013 concerning specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions [2013] OJ L287, 63 (hereinafter referred to as the SSM Regulation). Close cooperation is elaborated further in Regulation (EU) 468/2014 of the European Central Bank of 16 April 2014 establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities [2014] OJ L141, 1 (hereinafter referred to as SSM Framework Regulation), and Decision ECB/2014/5 of 31 January 2014 on close cooperation with the national competent authorities of participating Member States whose currency is not the euro [2014] OJ L198, 7.

“close cooperation”, is required to mandate the national authorities to abide by the ECB requests and guidelines. The right to suspend and terminate the “close cooperation” arrangement remains in the SSM framework. However, the commitment to join the Monetary Union minimises the ‘authority dilemma’ for the ECB since suspension and termination will become a non-issue. Hence, the incentive for simultaneous application to join the ERM II and to enter “close cooperation” is apparent, as the political commitment for joining the Monetary Union and Banking Union converge.

Close cooperation involves marked changes in the allocation of related powers. In the case of a subsidiary of Banking Union banks in a country outside “close cooperation,” the ECB as the apex of the SSM can effectively impose conditions on the subsidiary via the parent without formal involvement of the host supervisor. When a close cooperation arrangement is in place, ECB decisions addressed to supervised entities are replaced by instructions to the respective national supervisor (termed the National Competent Authority – NCA) and on occasion the macroprudential authority (termed the National Designated Authority – NDA). The higher the proportion of foreign euro area banks to domestic banks, the greater the need for cooperation and coordination in order to minimise information asymmetries and limit the risks of contagion from cross-border banking.

In fact, the ECB Decision on the establishment of close cooperation between the ECB and the central banks of Bulgaria and Croatia introduced representation of each of the central banks as a supervisory authority with voting rights on the Supervisory Board. Thus, entering into close cooperation in some ways expands the information and powers available to the host authorities. This helps to further internalize potential negative externalities derived from cross-border banking. Furthermore, the linkage of close cooperation to ERM II participation also had the crucial effect of binding those countries more closely to the Banking Union. It is more difficult for the supervisory authority to exercise discretion in implementing ECB decisions once it is committed to the path leading to full Monetary Union membership.

This is particularly relevant at the time of joining the ERM II. Dorrucchi et al. (2020) show that following the accession of countries to the EU, countries that participated in ERM II in 2004 and 2005 experienced a more pronounced international financial flow cycle than those which did not participate. Gross financial inflows in ERM II participating countries peaked about three years after they joined ERM II and were driven largely by bank lending to corporates and households, interbank lending between branches and subsidiaries of EU banks and, to a lesser extent, by inward foreign direct investment. Hence the rationale of a prior commitment to entering ERM II: This is entry into ‘close cooperation’ following the fulfilment of the necessary supervisory and legislative prerequisites.

On the macroprudential side, Bulgarian and Croatian banks will now be open to scrutiny by the ECB, which may request that they adopt or increase levels of capital and liquidity for the purposes of managing macroprudential risks.

**Bulgaria and Croatia were prepared to enter these arrangements because they saw little cost relative to current conditions and considerable benefits.** First, both countries have small, open economies that are strongly integrated within the euro area economy. Bulgaria and Croatia had tied their currencies closely to the euro, and have already committed to adopt the euro once they fulfil the necessary conditions. Second, their banking systems are already dominated by Euro Area banks. As shown in the following table that lists banks directly supervised by the ECB, all three top Croatian banks by market share are subsidiaries of Euro Area parents, and two of three top Bulgarian banks are similar subsidiaries. Euro Area subsidiaries hold 58% and 73% shares of banking assets in Bulgaria and Croatia, respectively. It is notable that the large hosted banks are subsidiaries of institutions that with the exception of Addiko Bank and Sberbank Europe are considered

systemically significant in their respective home country. One implication of this distribution is that, under close cooperation, no national bank would be supervised by the SSM; only the subsidiaries of foreign banks that fulfil the criteria to be classified as “significant institutions” by the ECB.

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

Banks directly supervised by the ECB	Affiliate of Foreign Bank	Ranking by Assets (National)	Total Asset Market Share
<b>Bulgaria</b>			
Unicredit Bulbank AD	Y (Unicredit Italy)	1	18.39%
DSK Bank Plc	N (OTP Bank PLC Hungary)	2	13.69%
United Bulgarian Bank - UBB	Y (KBC Belgium)	3	10.68%
Eurobank Bulgaria AD	Y (Eurobank Ergasias SA Greece)	5	7.78%
Raiffeisenbank (Bulgaria) EAD	Y (Raiffeisenbank Austria)	6	7.55%
Total			58.09%
<b>Croatia</b>			
Zagrebacka Banka DD	Y (Unicredit SPA Italy)	1	23.56%
Privredna Banka Zagreb D.D	Y (Intesa Sanpaolo Italy)	2	17.27%
Erste & Steiermarkische Bank DD	Y (Erste Group Bank AG Austria)	3	12.78%
Raiffeisenbank Austria D.D.	Y (Raiffeisenbank Austria)	5	10.14%
Addiko Bank d.d.	Y Addiko Bank AG Austria	8	5.17%
Sberbank d.d	Y (Sberbank Europe AG Austria)	9	2.99%
PBZ stambena štedionica d.d.	Y (Intesa Sanpaolo S.p.A. Italy)	15	0.60%
Raiffeisen stambena štedionica d.d	Y (Raiffeisenbank Austria)	26	0.40%
Total			72.91%

Source: Central Bank Data and IMF WEO (April 2020)

**The move towards centralisation of decision-making in bank crisis resolution and financial support based on mutualisation of funding are important incentives for entering close cooperation, to minimise the home and host dilemma associated to the asymmetry of information and the need to align incentives among safety-net regulators. This is particularly the case for countries that join the ERM II, which are particularly prone to credit booms and busts.**

With close cooperation, decision-making about resolution shifts from the national resolution authority to the Single Resolution Board (SRB), with the practical execution of the resolution scheme still residing with the former. A critical feature is the mutualisation of assistance through the Single Resolution Fund (SRF) that also includes the possibility of a backstop credit line from the European Stability Mechanism (ESM). A country entering close cooperation has to merge its national resolution fund into that shared by existing Banking Union members (SRF). The reforms to the ESM to introduce the backstop, which provides additional support to the SRF function of providing financial assistance during a crisis in a fiscally neutral manner, provide incentives to enter close cooperation by guaranteeing the benefits of this backstop to the SRF. In many respects this is appropriate given that those entering into close cooperation are required to mutualise their national funds, so they should also benefit from the backstop and indeed contribute to that effort. The reduction of autonomy is offset by access to a larger pool of funds and direct involvement in decision-making about the parent groups of significant banks in Bulgaria and Croatia once they join Banking Union.



Member States in close cooperation retain critical responsibilities for emergency liquidity assistance and precautionary recapitalisation of solvent banks that have short-term liquidity and capital assistance needs.<sup>7</sup> These responsibilities reside at the national level regardless of whether a Member State is in close cooperation or a full-fledged member of the euro area.

## Conclusion

The goal of expanding participation in the European Banking Union was to allow the ‘outs’ to enter into close cooperation, but it did not explicitly include the simultaneous joining of the ERM II. It now appears entry into ERM II requires entry into the Banking Union. This Policy Note seeks to assess the incentives for entering close cooperation for two countries that are also applying to become members of the EMU (Bulgaria and Croatia) by looking at three key areas: the duality of ERM II membership and entering close cooperation, the supervisory and the crisis management incentives for entering into close cooperation when joining the EMU is the ultimate objective.

The linkage of close cooperation to ERM II participation has the crucial effect of binding EMU-applying countries more closely to the Banking Union. It is more difficult for a national central bank or NCA to exercise discretion in implementing ECB decisions once it is committed to the path leading to full EMU membership. Hence the commitment to join the EMU minimizes the authority risk for the ECB as well as the SRB, as safeguards become insignificant and termination is not an issue. Uncertainty about the functioning and durability of the close-cooperation arrangement is largely removed. The incentive for complying with close cooperation when applying to join the ERM II is apparent, as the incentives for joining the EMU and being part of the Banking Union converge.

It is evident from our research that there are clear benefits of close cooperation for these Member States whose domestic currencies are already linked to the euro, in view of the dominant position euro-area banks have in their respective domestic markets and the role that those banks play in channeling the likely strong expansion of credit that goes hand in hand with the participation in the ERM II as shown in the latest round of participation (Estonia, Lithuania, Slovenia, Latvia and Slovakia).

In view of the ECB list of Bulgarian and Croatian banks that it supervises as of October 2020, a significant proportion of the total assets of the banking systems in Bulgaria and Croatia is brought under centralized supervision and resolution. In the cases of Bulgaria and Croatia, this means no national bank would be supervised by the ECB but only the subsidiaries of the foreign, mostly euro area banks. The case of Croatia suggests the importance that the ECB attaches to other aspects of determining significance, such the relevance of cross-border activity, when deciding the categorization of banks.

With close cooperation, decision-making about resolution shifts from the national authorities to the SRB, with the practical execution of the resolution scheme still residing with the former. It is argued that the SRB’s relationship with Member States in close cooperation within the SRM is therefore ‘equivalent’ rather than ‘comparable’, as with the ECB in the SSM. A critical feature is the mutualisation of assistance through the SRF, including the possibility of a backstop credit line from the ESM. This reduction of autonomy is offset by access to a larger pool of funds and direct involvement in decision-making about the parent groups of significant banks in Bulgaria and

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<sup>7</sup> Precautionary recapitalisation in Article 32(4) of European Parliament and Council Directive 2014/59/EU of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU and Regulations (EU) No 1093/2010 and (EU) No 648/2012 of the European Parliament and of the Council, and emergency liquidity assistance in Article 31.

Croatia regarding crisis resolution and its financing via participation in the SRB as well as attendance of backstop-related meetings of the Board of Governors and Board of Directors of the ESM as observers.

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

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