European Bank
for Reconstruction and Development

Europe's banking union in the global financial system: constructing open and inclusive institutions

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Abstract

The global reach of Europe's banks is extensive and their foreign operations have supported financial development in European host countries, as has the profitability of bank groups headquartered in Europe. However, financial fragmentation threatens to reverse these gains and is evident in terms of a withdrawal of global liquidity (external deleveraging), and in the segmentation of capital and liquidity pools within the foreign subsidiaries of European cross-border banks ("decentralised banking"). In light of this we examine the external ramifications of Europe's banking union constituted by a common supervision and bank resolution regime. We show that institutions, as presently designed, may stem global deleveraging but that they are likely to accelerate a move towards a more decentralised banking model. This second trend will be re-enforced by prudential ring-fencing on the side of the host country authorities, which is costly at both the host country and global level. Ring-fencing and banking decentralisation will therefore undermine the benefits of financial integration – both within Europe's single market and in non-EU emerging markets that have so far enjoyed full capital mobility intermediated within bank groups. However, where foreign host countries have no prospect of further institutional integration with the banking union, decentralised banking and certain prudential safeguards will be inevitable. In such a second-best setting these safeguards may be desirable from the perspective of the host country and the European Central Bank (ECB) in its new role as single supervisor.

Keywords: EU banking union, financial integration.

JEL Classification Number: F36, G28

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All views expressed in this paper are the authors' and should not be attributed to either the EBRD, its members, or the inter-institutional "Vienna Initiative" working groups, which the authors have supported. This paper was prepared for the conference "Crisis, Institutions, and Banking Union" at the German Finance Ministry on 16-17 June, and comments from all participants are gratefully acknowledged. In addition we thank Gonzalo Gasos, Andrzej Reich and Nicolas Veron for very helpful comments; Marcin Tomaszewski provided valuable research assistance.

Working Paper No. 175 **Prepared in October 2014**

1. Introduction

Europe’s banks account for almost half of global banking assets, and have developed extensive international ties through their branch and subsidiary networks. Bank groups are deeply engaged in a number of emerging market regions, particularly in Europe’s periphery and Latin America, controlling institutions that are systemically important and account for a significant share of banking sector assets within host economies. When in 2011-12 parts of the eurozone suffered parallel sovereign and banking crises, a global bank deleveraging process ensued and exerted pressure on credit markets in foreign host countries, and in some instances led to wholesale withdrawal by individual EU banks.

The European banking union represents a fundamental reform of institutions governing EU banks and is designed to defuse risks from variable standards in supervision and from the destructive interaction between sovereign and banking balance sheets. It has been designed primarily for countries in the eurozone, although other EU members are invited to accede. With the first element – common supervision – coming into effect from November 2014, confidence in the eurozone banks may gradually be restored. In the view of its proponents, this will strengthen parent banks and their subsidiaries alike, supporting Europe’s global banking business.

Yet international banking linkages have been an afterthought in the design of the new institutions, and regulators outside the eurozone view this redesign with some concern. Established coordination with the supervisor responsible for the parent bank (the individual EU home country) will now be superseded by common ECB supervision. The new EU arrangements for bank recovery and resolution remain complex and possibly under-funded, and the failure of a cross-border bank a no less cataclysmic scenario. It is far from clear that the new mechanisms will improve on the established coordination between large host countries with key EU home authorities, such as Austria, Italy or Spain. Should the problems in information sharing and crisis coordination persist, regulatory ring-fencing by host countries may well continue. There is a clear risk that the gains from subsidiary banking and financial integration with Europe’s core will be gradually eroded.

Given this spectre of further financial fragmentation, the external ramifications of Europe’s banking union should be examined much more closely, now that its first elements have come into effect. Our paper assesses the changes that the centralisation of supervision and bank resolution powers within Europe’s banking union will entail for supervisors outside the eurozone. We focus on emerging market host economies, in which eurozone banks play a significant role, as this is where this changed relationship will be most apparent. We assess these changes first on the basis of changed incentives for the common supervisor and its interaction with foreign hosts, and then illustrate these changes by examining the reactions of key host economies.

While all EU countries outside the eurozone are invited to accede the banking union, as yet only Romania has declared its intention to do so. We will suggest a number of legal and procedural steps that could make such an accession more attractive. For other emerging market host countries, such as those in Latin America, we identify a number of ways to ensure that the centralisation of supervision and resolution powers will not erode the effective coordination mechanisms that have been established with individual EU home countries.

Our short paper is organised as follows. In the next section we examine the extent of foreign engagement by eurozone banks, and compare the external deleveraging in two principal emerging markets regions: central and eastern Europe (CEE) and Latin America. The parallel sovereign and banking crises in the eurozone in 2011-12 presented the most dramatic shock to these banking relationships and we review the empirical research as to why banking networks in Latin America proved much more resilient than those in emerging Europe. In section 3 we then sketch the defensive regulatory measures that a number of emerging markets – both inside the EU and outside it – have taken in response to the risks of contagion from eurozone parent banks. "Ring-fencing" has the potential to protect the host country banking sector and taxpayer, though will generally be costly for parent banks' capital planning and may well come with negative externalities for third countries. In section 4 we examine the key changes that the common supervision and common resolution regime within Europe's banking union will entail for home-host cooperation, and assess how the incentives for information sharing and ring-fencing are likely to change. Section 5 reviews the options for specific groups of countries – non-euro countries inside the EU, non-EU countries in the European Union's immediate neighbourhood, and emerging markets elsewhere. We set out a number of incentives these countries may see for closer cooperation with the new institutions. Finally, in section 6 we conclude with a small number of proposals as to how the new institutions could be adapted to construct a more open banking union – in terms of creating incentives for membership by EU members outside it – and for closer cooperation by non-EU emerging markets, both in Europe's immediate periphery and in other regions.

2. Europe's fraying global banking networks

At the end of 2013, eurozone banks held about €4.7 trillion in claims on external counterparts.[1] Relative to the total assets of euro area banks of €30.6 trillion this is a substantial exposure. Europe also clearly dominates international banking. Once intra-eurozone exposures are netted out, euro area banks' external claims account for almost 24 per cent of the global total, easily exceeding equivalent shares of the United States or Japan, which both stand at about 10 per cent. Arguably, the eurozone's global clout in international banking transcends that of other areas of international commerce, such as exports or foreign direct investment.

Looking more narrowly at emerging markets only, the ECB estimates that claims by euro area banks stand at €1.6 trillion, which represents about 45 per cent of total external bank claims on this group of countries.[2] These figures underline that the external aspects of Europe's new banking union will be studied by foreign partner countries with keen interest, and especially so in emerging markets.

Given the history of bank privatisations and rapid financial liberalisation, what stands out regarding emerging markets is the very high foreign ownership of banking assets, well above that in most advanced markets (see map below). Bank ownership links have evolved around trade patterns and historical links. For instance, a small number of Austrian and Italian banks dominate banking sectors in emerging Europe, and those from Spain and Portugal dominate in Latin America. Moreover, ownership shares are not just high and concentrated among a small number of home countries, but within those host countries foreign bank subsidiaries typically also account for the most important, and systemically relevant, institutions.

Emerging markets initially sought to attract foreign banks because of their superior corporate governance standards, risk management practices, skills and technology. Even after the financial crisis and its rapid international transmission, the benefits of openness to foreign banks are on the whole still appreciated. The presence of foreign banking institutions diversifies funding sources of the local real economy, and empirical studies generally confirm that financial stability within host countries will be less prone to shocks from within the local economy.[3] Of course the financial strength of the parent bank is a key determinant of the capacity to withstand local shocks, or of growth in credit portfolios.[4] During the financial crisis the three Baltic economies, for instance, clearly benefited from the funding capacity of the Swedish banks that dominated these markets.

Emerging market banking exposures account for a sizeable share of the foreign assets of eurozone banks overall, and they have also been the source of a disproportionately large share of total earnings.[5] For this reason, to date, the coordination between a number of

[1] Our estimate is based on the foreign claims of the 11 largest eurozone countries, from which intra-eurozone claims have been netted out. This and all following figures are for consolidated claims (BIS table 9b), which include the local claims of the foreign affiliates of eurozone banks, even though, of course, such claims are predominantly funded within host countries.

[2] ECB (2014).

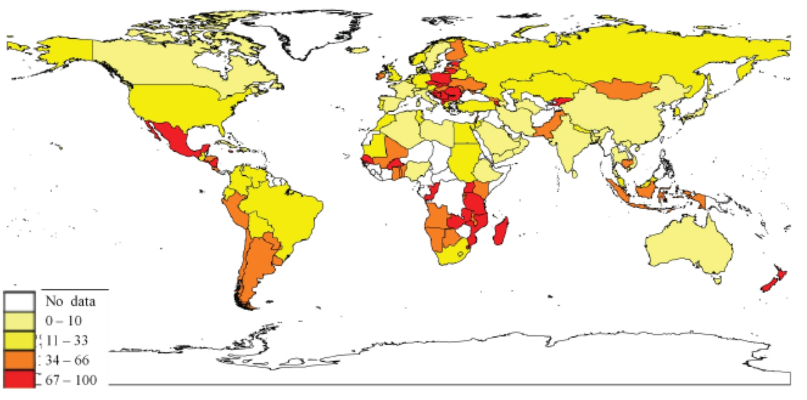
[3] Cull and Martinez Peria (2010).

[4] De Haas and van Llelyweld (2011).

[5] IMF (2011).

national home supervisors, such as those in Austria, Italy and Spain, with individual emerging market hosts has been very close. For these host markets this collaboration has offered valuable capacity building, facilitated access to the EU supervisory colleges and smoothed the management of the recent bank deleveraging. The experience of the emerging market hosts in adapting to the integrated banking union institutions will be highly instructive, well beyond the emerging markets world itself.

Foreign bank ownership shares around the world



Note: Foreign-bank assets are shown as a percentage of total banking assets.

Source: Reproduced from de Haas (2012).

2.1 Bank funding models: their impact on host country supervision and resolution

The recent crisis of euro area banks has amply underlined the risks that external liquidity shocks pose to host country bank supervision. But two other developments have been under way that explain a much more assertive stance that supervisors have adopted regarding foreign bank affiliates within their jurisdictions. First, supervisors have drastically improved capacity and skills, which allows them to monitor even more complex operations. And second, in light of a number of cross-border bank failures, legal frameworks and fiscal capacity for bank resolution have been put in place. Ten years ago the Basel Committee of Bank Supervisors set out a model for cross-border supervision in which the host largely deferred to the home jurisdiction where liquidity and operational management were centralised in the parent.[6] This model can now be safely considered outdated.

From the host's perspective, the funding model of the bank group will be the defining parameter of supervision and the potential burden in a crisis or resolution scenario. In emerging markets foreign bank affiliates have overwhelmingly moved away from branch offices towards the subsidiary model, which gives host authorities full prudential powers. Many hosts have indeed actively encouraged international banks to move towards such a model, most recently in India.

A key benefit from international banking stems from integrated risk management systems, centralised operational control, for example in IT systems, and a common skills base. Retail depositors and borrowers alike take comfort from these assets that are shared across the

[6] BCBS (2003).

international network, as signified in a common bank brand. That said, subsidiary systems operate with widely different models of liquidity and capital management, each presenting very different challenges to local supervisors.

At one extreme are the subsidiaries of the Spanish bank groups which show among the highest degrees of reliance on host country funds, and among the lowest shares of intragroup funding.[7] Key hallmarks of this model are that transactions between parents and subsidiaries are subject to strict limits and conducted at market prices. If managers of these banks are to be believed, there is no parent guarantee of subsidiary liabilities, and support to the subsidiary through group funds is limited to exceptional operational risk. Subsidiaries are autonomous in terms of capital and liquidity planning, although of course remain subject to group-wide and host country supervision. This clearly moves the subsidiary balance sheet closest to the control of the host country jurisdiction.

At the other extreme, the centralisation in the parent bank of capital and funding decisions is more common in the Austrian or Italian bank groups that dominate banking sectors in central and south-eastern Europe. Here, capitalisation and funding decisions are essentially coordinated centrally, and an integrated internal risk model is presented to both home and host country authorities.

This centralised model clearly preserves the benefits of intermediating capital and funds between markets. Within the banking union with its centralised supervision and pooled resolution powers this is the natural model to adopt (and indeed it is equivalent to the branch system). For emerging markets, however, the decentralised model holds advantages for the host regulator in simplifying potential bank resolution procedures and delineates more clearly the respective responsibilities in supervision and potential fiscal liabilities of home and host country authorities (and we will return to the regulatory measures that have reinforced this model in the next section).

2.2 Recent deleveraging trends

In the wake of the 2008-09 financial crisis parts of the global banking industry entered a protracted phase of deleveraging – asset reductions with a view to improve solvency.

The pattern of deleveraging by European bank groups has differed between types of financial products, maturities and geographic regions, with most banks applying a “pecking order” of asset classes for disposal or divestment.[8] Once the global liquidity crisis had exposed the excessive dependence of certain subsidiaries on funding through the parent and foreign wholesale finance**,** exposures to foreign subsidiaries were in the spotlight for deleveraging. The recent ECB Financial Stability Report underlines that this reduction in external assets has been particularly pronounced for euro area banks from the vulnerable countries in the eurozone’s periphery. Between June 2012 and March 2014 alone these asset reductions amounted to almost €250 billion, or about 22 per cent of the overall asset drop.

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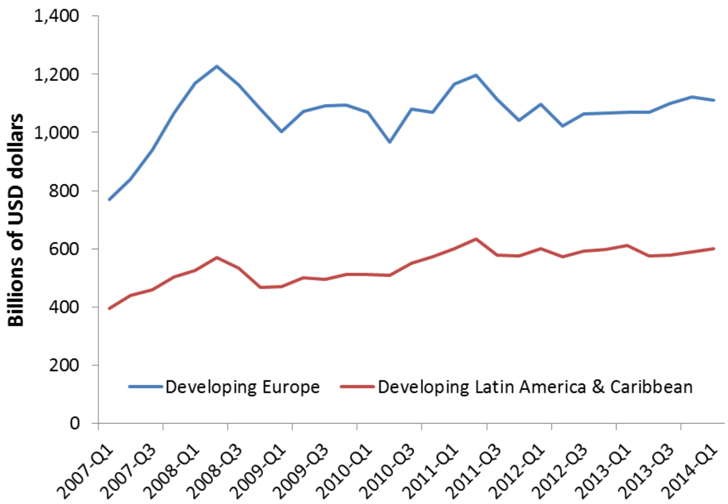
[7] BIS (2010a), the relative segmentation of bank-internal capital markets of the Spanish bank groups in Latin America in the early 2000s was guided by a “framework of good practices” adopted by the Bank of Spain; see also BIS (2010b): The architecture of global banking: from international to multinational?

[8] IMF (2012).

In the view of most observers, this deleveraging of external exposures by European banks was directly related to the deteriorating capital positions within parent banks, including that stemming from the concentrated exposures to the respective sovereign debt markets of their home jurisdictions. Others contend that this process has been reinforced by regulatory pressures that explicitly or implicitly discriminated against foreign subsidiaries, though of course this is strongly rejected by home supervisors.[9]

Overall, data from the Bank for International Settlements (BIS) indicate that between the peak of exposures in the first quarter of 2008 and the trough in mid-2012, euro area banks reduced their foreign exposures by 38 per cent (though this figure is to a considerable extent explained by reductions in, and netting out of, derivative positions). Within emerging markets this trend is more varied, with a reduction of about 13 per cent vis-à-vis emerging Europe, and in fact a measurable increase by 9 per cent vis-à-vis Latin America over the same period. While there was a brief withdrawal of liquidity in both regions in the immediate aftermath of the global liquidity shock in 2008, only the CEE region has seen a continuous withdrawal of funds since mid-2010. The IMF estimates funding withdrawals of about 1.5 per cent of host country GDP in 2013 alone, and of over 10 per cent cumulatively since 2008 (Chart 1).[10]

Chart 1: Eurozone bank exposures vis-à-vis emerging Europe and Latin America



Source: BIS data on consolidated claims, and authors' calculations.

Even though several Latin American markets are as closely exposed to eurozone bank presence as the CEE region is, on the whole these markets displayed much greater resilience than the CEE countries. Empirical studies of this striking divergence point out that cross-

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[9] A controversial case in point was the decision by the Austrian supervisor in late 2011 to impose limits on the marginal funding ratio of key bank groups in the CEE region, which according to statements at the time was designed to prevent the re-emergence of stretched funding ratios.

[10] EBCI/Vienna Initiative CESEE Deleveraging and Credit Monitor, May 2014, available at www.vienna-initiative.com.

border lending to national banking sectors has been very low. In fact, banking system funding in Latin America came primarily out of local deposits, which is in contrast to emerging Europe with its more direct dependence on parent and foreign wholesale funding.[11] An added support was of course that, following experience in a number of financial crises, foreign banks' lending within Latin American host countries was primarily in domestic currency. In contrast many CEE economies with their as yet underdeveloped local capital markets had experienced extensive lending in foreign currencies, including the Swiss franc. This experience seems to have validated the prudent stance of Latin American supervisors, and may in fact have led to even more stringent requirements on local liquidity management.

[11] Kamil and Rai (2010).

3. Regulatory ring-fencing: the rational response to unclear coordination in supervision and crisis management

For many years international discussions on crisis management and resolution have been grappling with the risk of disruptive liquidity transfers. In emerging markets with their history of financial crises the presence of foreign-owned subsidiaries was seen as an insurance. Indeed, the empirical studies we referred to above have confirmed the role of multinational banks in smoothing out host country liquidity shocks through recurrent transfers. The euro area crisis of 2010-11 put this relationship on its head, most strikingly perhaps when credit ratings for some Mexican bank subsidiaries briefly exceeded those of their Spanish parents.

Given the heightened uncertainty and restricted information flow during crisis situations in the home country, the host supervisor will have a strong incentive to restrict liquidity transfers, and may in fact impose more onerous capital requirements in anticipation of problems with home country exposures. Such so-called ring-fencing measures aim at a geographical separation of subsidiary liquidity and capital, and have indeed become increasingly common over the past years. Typically they take the form of prudential requirements on capital and liquidity that exceed international norms or home country standards, such as restrictions on dividend payments or on intra-group funding flows, including subsidiary exposures to the parent. [12]

This greater assertiveness of host country supervisors has been made possible by the gradual improvement in the quality of regulation and in the practice of supervision. Greater macroeconomic stability also helped. Unlike in the immediate aftermath of the emerging market crises 12 years ago, a sovereign’s capacity to issue debt in international capital markets, including for the purpose of capital injections in the local banking sector, is no longer questioned.

In a recent survey (EBRD, 2012) it was found that ring-fencing measures became increasingly common in emerging Europe, especially during 2011 when deleveraging pressures within Europe were at a peak.[13] In addition, banks regularly point to informal communications by supervisors, or bank-specific guidance under the less formal “pillar II” process of supervision. These measures were typically presented as being within the remit of prudential safeguards for the national banking system, although within banking systems dominated by foreign subsidiaries they in effect restricted the mobility of capital and liquidity within cross-border bank groups. While this is at odds with principles of capital mobility within the European Union’s single market, as yet no case of rules infringement has been pursued by the European Commission. In Latin America similar tendencies to ring-fence national banking systems were evident. Yet, given the much more decentralised business

[12] D’Hulster and Otker-Robe (2014).

[13] For instance, the Czech regulator has restricted banks’ related party exposures and the Polish regulator has restricted dividend payments where banks do not meet capital adequacy standards well above the regulatory norm.

model and treasury management practised by the Spanish bank groups, these subsidiaries were much better prepared and, in fact, fewer complaints were made public.[14]

Moving from a world of integrated capital and liquidity management within the single treasuries of cross-border bank groups towards ring-fenced national banking markets will result in considerable additional capital requirements. The parent will need to provide additional capital buffers within each subsidiary location to protect against country-specific shocks to credit quality. In the case of emerging Europe for instance, an IMF simulation suggests that up to three times more capital could be required than in the context of fully integrated banking markets where both excess profits and excess capital could be freely redistributed.[15] Such inefficient capital allocation may ultimately undermine the very rationale for the subsidiary-based banking model – and indeed threaten much of the gains achieved by cross-border banking in Europe.

[14] In Mexico recent prudential measures tightened the rules for related party lending (that is, including from the subsidiary back to the parent), requiring authorisation for all transactions exceeding 25 per cent of tier one capital within each year. It is likely that across Latin America, as in other emerging markets and developing economies many such measures have in effect imposed informal interventions or "moral suasion" in day-to-day supervision, with the similar effect of restraining the freedom of capital and liquidity transfers.

[15] Cerutti et al. (2010).

4. Europe's banking union and the emerging markets: some unintended consequences

Since the onset of the financial crisis in 2008, the legal and regulatory environment facing global banks has changed dramatically. The Basel III package of prudential standards has increased the need for more and higher quality capital in banks in the G20 countries, and gradually this framework is being adopted in emerging markets. This has been complemented by a number of regulatory reforms coordinated by the Financial Stability Board (FSB), including additional capital requirements for systemically important banks, and better coherence in national regimes for cross-border resolution of such institutions.

In Europe, the implementation of successive elements of the banking union represents a fundamental redesign of the institutional framework for the supervision of cross-border banks. As a first and crucial element, the regulation conferring supervisory powers to the ECB was adopted in October 2013, and the Single Supervisory Mechanism (SSM) initiated work at the ECB in November 2014. Resolution issues were not high on the political agenda until the crisis exposed the costs of neglecting them. The second pillar of the banking union was then put in place in the form of the Bank Recovery and Resolution Directive (BRRD), which applies to all EU members effective from 2016. Within the banking union itself, the Single Resolution Mechanism (SRM) will provide common oversight, ensure consistency and, to a limited extent, mutualise funding.

The fact that two important pillars of the banking union have been established in a very short time is impressive. Yet the sharing of banking sector risks among participants of the banking union remains controversial. This is underlined by the stalemate over a final element in the banking union construct – a common deposit guarantee scheme – where for now no concrete plans are being considered.

4.1 Common supervision

Under the SSM regulation, powers of supervision will cover all credit institutions established in participating countries (eurozone countries, although also other EU countries which may yet decide to "opt-in"). Common supervision will be limited to *significant* credit institutions, essentially those with assets in excess of €30 billion or which are deemed significant due to the size of total operations in several participating countries.

To date, 128 EU banks have been designated to be part of this group, including all principal banks with stakes outside the European Union. Once an institution is subject to the SSM, the ECB assumes the role of primary supervisor of all subsidiaries in participating countries, and of home country supervisor in interactions with countries that are host to other subsidiaries. National bank supervisors will continue to have direct responsibility over "less significant" institutions, although here too the SSM may assume direct supervision under certain conditions.[16]

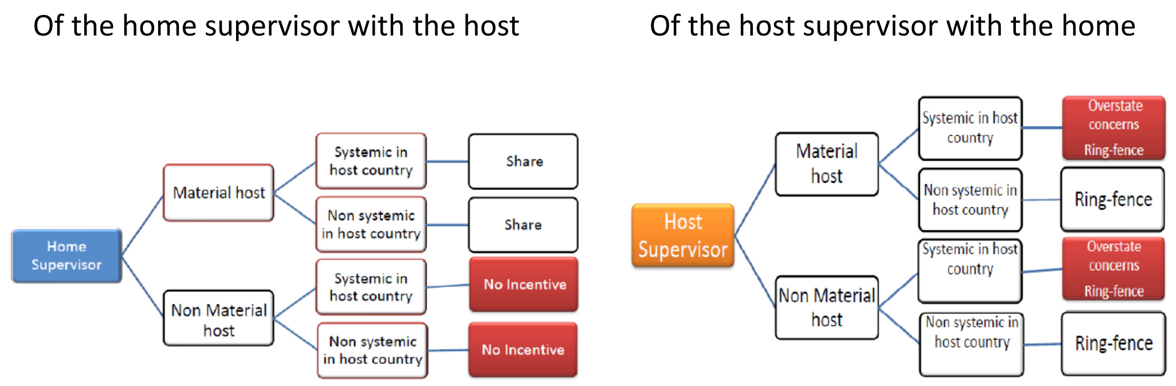
[16] Both the national supervisor of a participating banking union country and the ECB will have competencies over macro-prudential supervision, importantly through additional system-wide capital requirements as they are envisaged under the Capital Requirements Directive IV.

In the immediate future, key home country authorities, for instance at the Bank of Spain in the case of most Latin American bank subsidiaries, will continue to conduct most day-to-day supervision in the Joint Supervisory Teams. Over time, SSM staff will gradually take over more direct control. Given the close collaboration that emerging market host countries have enjoyed with key home countries of EU bank groups, such as Austria, Italy or Spain, this centralisation of responsibilities will entail a number of challenges.

A key constraint to both home and host supervisors taking timely action is typically inadequate information sharing. A technical, though important, complication lies in the lack of confidentiality agreements that are required if non-EU countries are to access the "core" supervisory colleges of EU bank groups, where all key decisions are taken. For non-EU countries, the European Banking Authority (EBA) will continue to be the key counterpart to facilitate such access. However, the EBA has no mandate to initiate such assessments outside the European Union (and no budget set aside for this purpose).[17]

The more fundamental constraint lies in diverging incentives. A decision tree produced by D'Hulster (2011) and reproduced in Chart 2 illustrates the different outcomes. Essentially, the home supervisor has two different strategies of either sharing accurate and timely information or of minimising, and possibly obfuscating, information from institutions under its authority. Only where the host country is material to the banking group will such information sharing be optimal; in all other cases there is no clear incentive either way. From the host's perspective, there is a clear incentive to share information with the home supervisor as long as the subsidiary is systemic within its own financial market. In summary, unless the subsidiary has systemic relevance within the host market and that market is significant from the perspective of the bank group, cooperation breaks down. Very few subsidiaries meet both criteria – likely those of Spanish bank groups in some Latin American countries, and some subsidiaries of Austrian, French and Italian groups in a small number of markets in emerging Europe. Generally the subsidiary is systemic from the perspective of the host country, but not for the home country.

Chart 2: Incentives for information sharing



Source: D'Hulster (2011).

[17] That option exists in principle, should a third country make a request for such an assessment to the EBA.

How will the incentives for cooperation and information sharing change, once responsibilities shift from national EU supervisors to the ECB? According to the regulation the SSM is tasked to safeguard financial stability both in the entire European Union and in each member country (whether participating in the banking union or not).[18] The integrity of the internal market and guarding against the risks of regulatory arbitrage figure prominently in the first paragraph of the SSM's mandate. In taking over the role of home supervisor for subsidiaries outside the banking union the ECB should in theory still be guided by the original objectives of the respective national supervisor of the parent bank.

In fact, some benefits may arise from centralisation. Take the case where subsidiaries from several SSM countries are exposed to similar risks within an individual host outside the banking union. In that case, the host may alert the ECB to broader ("macro-prudential") risks that may subsequently require a response by several bank groups that fall under the SSM. Centralised supervision now internalises macro-prudential concerns that individual EU home supervisors previously would not have registered. A more proactive response by the SSM is likely when compared with the previous world of disjointed supervision by individual EU home countries. This case of eurozone banks being collectively of systemic importance is particularly relevant in Croatia, for instance, or in smaller countries of the western Balkans where the joint ownership by eurozone banks often exceeds 70 per cent of local assets.

As far as smaller subsidiaries in non-EU markets are concerned, host concerns may still not register as relevant from the SSM's assessment of the integrated group. Centralised supervision may in fact be *less* responsive to the specific circumstances of subsidiaries. The move towards centralised supervision within the ECB could undermine many informal cooperation arrangements that existed between national supervisors. This is a particular concern for countries in Latin America which enjoyed privileged information-sharing arrangements with their respective partner institutions in EU home countries.

There is a more wide-ranging change to the practicalities of supervision which will apply to all EU members, not just those participating in the banking union. The SSM will apply the so-called single rulebook as defined by the EU Commission and European Banking Authority (EBA), and thereby seek to ensure more consistency in information sharing and supervision. This will entail a more uniform and impartial treatment of foreign host countries. For non-EU host countries with subsidiaries from several EU origins this new structure may well facilitate cooperation. No doubt having a single authority to deal with in Europe instead of several national home supervisors will be positive.

In implementing the substance of the EBA rule book, centralised supervision by the SSM could make a real difference to the prudential norms as presently applied in subsidiaries. So far, the approval of banks' internal risk models or the recognition of local assets for the purposes of complying with liquidity or capital requirements has benefited from numerous exemptions granted by individual home authorities.[19]

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[18] Art. 1, Council Regulation No. 1024/2013, with an interpretation in Darvas and Wolf (2013).

[19] In particular the recognition of host country sovereign assets for the purposes of new liquidity ratios and the recognition of local, as opposed to international, risk ratings for the calculation of risk weights has been a concern for important emerging market home countries. See for instance FSB (2012).

A key area in need of uniform treatment has been the classification of non-performing loans (NPLs), which continue to plague many banking systems. So far, the NPL overhang, and the lingering doubts over true capital positions have led banks to contain fresh business and retrench from certain types of exposures. Surveys of international banks demonstrate that given this NPL overhang, credit lines to foreign subsidiaries and foreign corporate clients are among those exposures most likely to be cut.[20]

In future, standards for NPL classification for regulatory reporting will be harmonised across the entire European Union.[21] On this basis the systemically important banks that will enter the SSM have now undergone a comprehensive asset quality review (AQR) and accompanying stress test, thereby establishing residual capital needs. AQRs and stress tests will be run on a consolidated basis, and include subsidiaries and branches *outside* the SSM area. On present plans, non-EU host country supervisors will not see the ECB's findings for subsidiaries in their countries, although this could be helpful to these host authorities. It appears that parent banks are now ready to roll out this stricter loan classification and subsequent provisioning to their non-EU subsidiaries as well, which should benefit this process of balance sheet cleansing.

4.2 The common resolution regime

Until recently, the clarity of bank resolution regimes within EU members varied widely. The perception that certain institutions were "too big to fail" induced moral hazard and risk-seeking lending practices, and ultimately resulted in substantial bail-out costs borne by taxpayers.

The deteriorating health of euro area parent banks was therefore a key concern for emerging market host countries in 2011-12. In addressing distress within a cross-border bank the underlying incentive problems of cross-border supervision are thrown into sharp relief. The home country authority, which remains accountable to national taxpayers, will restrain cooperation with the host.[22] In interacting with the host the incentive is to minimise the extent of the problem and to delay sharing of information. Liquidity and capital repatriations from the subsidiary to the parent are likely condoned by the home authority. The host authority, for its part, will seek to continue good relations, share largely truthful information on the subsidiary, though will likely adopt a strategy of protective ring-fencing. Where resolution arrangements are unclear a cooperative strategy that can preserve higher value post restructuring is unlikely. Conversely, where the subsidiary is the root of the problem, host country ring-fencing is likely to be coupled with an exaggerated presentation of the extent of the problem to the home country. Either way, in a crisis situation supervisory coordination and information sharing will meet increasing resistance, and may even break down entirely.

This major gap in the financial architecture was spelled out by the G20 in the immediate aftermath of the crisis. For the 29 global systemically important banks (the so-called G-SIBs),

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[20] IMF (2011).

[21] The EBA released technical standards on NPLs and forbearance reporting requirements in October 2013.

[22] Again, see D'Hulster (2011) for an illustration of different strategies by home and host countries.

of which the eurozone has seven, the agenda is pursued through work on the recovery and resolution plans for each institution.

For all other EU banks the BRRD responds to the ambition of establishing clear resolution frameworks and cross-border coordination. The Directive sets out steps for crisis prevention, and mandates national authorities to adopt resolution plans for all banks from 2016; it defines resolution tools for early intervention; and it provides for bail-in tools that aim to minimise taxpayer costs.

These provisions for creditor bail-in are a clear achievement of the Directive. New provisions adopted by the Commission in July 2013 make the bail-in of junior creditors a condition for the provision of state aid. Under the new procedures bond holders and even large uninsured depositors under certain circumstances can lose their money in a resolution process, including before a bankruptcy. Once in resolution, bail-in will proceed along a reasonably clear hierarchy of creditors.

The Directive recognises that national resolution bodies will need some discretion since the funding pattern of banks will vary considerably between EU countries, particularly in the degree of deposit funding. Although discretion may result in an unequal treatment of some creditors in a cross-border bank crisis, it might in certain cases be necessary to preserve national financial stability. Still, the criteria for the use of discretionary powers remain somewhat vague. Crisis situations may give rise to large and sudden cross-border deposit flows, in particular once market participants suspect differences in bail-in procedures. This uncertainty may well increase the cost of funding for banks.

Irrespective of national specifics, by the time a resolution scenario is reached, a “minimum requirement of eligible liabilities and own funds” will need to be in place for bail-in, normally at least 8 per cent of the bank’s liabilities.

Within the eurozone, the SRM will complement common supervision, ensure consistency of resolution plans through integrated crisis resolution, and at a later point mutualised funding. Countries that opt to join common supervision automatically will be part of the SRM as well. However, the centralisation of authority and establishing a transparent decision process has been less straightforward than in the SSM. A network of national authorities and the Single Resolution Board (SRB) will be established and will be responsible for handling the possible resolution of the systemic banks under SSM supervision.

The decision-making process in resolution will be complicated, which is a result of member states insisting on multiple safeguards, checks and balances to be included in the framework to limit risks to national budgets. The SRM will have to apply different national legislations in different countries, and these have not yet been harmonised. This will likely constrain the speed of action in resolution and increase uncertainty about final outcomes.

For countries outside the European Union that participate in cross-border resolution, the process within the SRM is unlikely to be transparent, and decisions will be hard to predict. The process in its current shape seems well suited to handle resolution cases that can be carried out in a fairly predictable manner over an extended period, rather than cases of acute crisis management. The steps to be taken and the large number of authorities involved will hardly permit solving a crisis in a bank swiftly. Such crises will most likely have to be handled, at least initially, by national authorities on the basis of the instruments provided by the BRRD.

The Single Resolution Board will naturally focus attention on the SSM countries. It will be a challenge for the SRB to commit sufficient resources to evaluate the impact of its actions on non-EU host countries, even if subsidiaries of a bank under reconstruction are systemic from the point of view of the host country. The parent bank will have a clear interest in safeguarding the viability of the subsidiary. Yet there is no clear process under which non-EU host country authorities may be invited to participate in the resolution college.

The funding of resolution procedures is still open to discussion, particularly when it comes to mutual responsibilities in cross-border resolution. In the immediate future, national resolution funds will be established from bank levies, with a target level of 1 per cent of covered deposit within 8 years. Over the same period, a gradual mutualisation of funds will be allowed, and ultimately a very limited backstop through the European Stability Mechanism (ESM) will be available to euro area countries.

A key question is how these new institutions and processes will work with countries outside the European Union. In defining the resolution plans for cross-border banks, the location of the bail-in funds will be a key point of contention. Some articles of the BRRD offer limited options for access to resolution colleges by third countries.[23] Non-EU countries can be invited to participate in resolution colleges, but are not given a right to do so. In any case, non-EU countries that want to participate in resolution colleges – notably those that have big subsidiaries of euro area banks – will have to provide a resolution fund and some fiscal backstop facility for such a fund in order to become credible participants in the discussion.

As regards the large cross-border bank groups that are defined as globally systemic, this discussion will be guided by the FSB. We documented above that cross-border bank groups increasingly adopt more decentralised business models under which subsidiaries are funded and managed on a stand-alone basis. Emerging market host countries, in turn, have put in place more effective resolution powers, which are increasingly backed by credible fiscal backstops. These trends suggest that resolution of large cross-border banks will in many instances need to be planned on the basis of a *parallel* application of resolution powers. In this light the FSB proposed resolution procedures along regional or business lines (the so-called "multiple point of entry" procedure).[24] Yet, the complex internal institutional set-up of the SRM seems ill-suited to accommodate such a concept of parallel resolution processes for a broader set of institutions.

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[23] With regard to the interaction with third countries, provisions in the BRRD are scarce. The Directive envisages that resolution plans that cover bank groups with affiliates outside the European Union shall "identify appropriate arrangements for cooperation and coordination with the relevant authorities of those third countries and the implications for resolution within the Union" (Art. 7.6a (d)). Art. 30 clarifies the competence of the SRB to represent all participating member countries vis-à-vis other EU and third countries. In relations with institutions headquartered outside the European Union the SRM has no mandate. The ambition is that "in order to ensure a coherent approach vis-à-vis third countries, it should be avoided, as far as possible, that in the participating Member States divergent decisions are taken with respect to the recognition of resolution proceedings conducted in third countries in relation to institutions or parent undertakings which have subsidiaries or other assets, rights or liabilities located in the participating Member States."

[24] Financial Stability Board (2013).

In sum, as with the SSM, the centralisation of resolution powers may hold certain benefits for non-EU host countries. The SRM will likely reduce transaction costs for emerging market hosts, as it establishes itself as the single counterparty defining crisis management and resolution strategies with key eurozone banks. Whereas previously individual eurozone home countries will have ignored the potential externalities of individual action, for instance of aggressive deleveraging by a parent, the new SRM will internalise these costs and arbitrate between conflicting national strategies. Where a non-EU emerging market is host to banks from a number of euro area countries, incentives may point to a swifter and more cooperative strategy.

Similarly, where the host resorts to ring-fencing in response to problems within a particular subsidiary, such capital account restrictions will affect other euro area banks, and likely lead to an earlier engagement by the SRM. Where the host only has banking stakes from one or very few euro area countries, its concerns may still fail to figure prominently within the SRM. It is unlikely that comprehensive and credible resolution plans can be agreed swiftly – not for the global SIFIs under the FSB's framework, let alone for the numerous other EU cross-border banks. Once work on these plans begins in earnest, the composition and location of bail-in funds will likely be a key point of contention with emerging markets.

5. Alternative paths of engagement by the "outs"

As became blatantly clear during the crisis, many countries in Europe's single market, including in the euro area, suffered from weak banking systems and inadequate financial supervision that was poorly coordinated between countries. The Single Supervisory Mechanism is now well advanced in addressing this problem. From the perspective of host countries outside the euro area, joining or closely cooperating with the SSM may well offer benefits of credibility, access to information, and a more predictable framework for crisis management.

For non-euro EU members the SSM regulation foresees the option of "close cooperation", under which the national supervisor will in effect accept instructions from the ECB on supervision as is the case for any euro area member. [25] The crucial difference is that the national central bank retains instruments for liquidity support to the domestic banking system, and independent monetary and exchange rate policies will over time generate destabilizing credit booms. As with all other SSM members the ECB will only share responsibilities with national authorities over macro-prudential policy instruments that could stem such systemic risks from overly loose monetary conditions. Allowing opt-in countries to benefit from the credibility of integrated supervision, and mutualised resolution funds in this case would engender a moral hazard problem, and non-euro opt-in candidates may seek to give greater assurances in sharing macro-prudential policy instruments. Moreover, these EU countries will not have full access to all decision-making bodies within the ECB, and for this reason a number of safeguards have been put in place.[26]

The ECB has argued that such an "opt-in" should be desirable, given the greater credibility that the preceding stress tests and recapitalisation would offer.[27] According to such entreaties, the SRM will provide increased credibility to the resolution process, diminishing the need for protection of domestic interests in participating countries. Hence, a better basis for fair and equitable resolution procedures than in existing cross-border bilateral agreement should be in place.

Until recently, this case for opting-in has not been compelling for any of the six new EU member states in central and south-eastern Europe, which are outside the euro. In Poland, the subsidiaries of the six largest eurozone-based banks account for almost 40 per cent of national banking assets. The National Bank of Poland and the financial supervisor have closely collaborated with the ECB, including by running a national asset quality review and stress test in parallel with those of the ECB.

Yet, the debate in Poland so far has largely been framed in terms of the merits of the banking union *per se*, as a decision on euro accession remains on hold in light of constitutional complications. While the opt-in has been proposed by some, so far the sceptics appear to have prevailed with concerns over the inadequate access to the ECB decision-making bodies,

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[25] Art. 7, Council Regulation 1024/2013.

[26] Specifically, the regulation gives an opt-in country the right to exit after three years, and a special review procedure by the ECB Governing Council, and, if the Council confirms the supervisory decision under dispute, the option not to comply with this decision. At that point the ECB in turn may suspend the close cooperation.

[27] "Banking union – essential for the ins, desirable for the outs!" Speech by Joerg Asmussen, Stockholm, 5 November 2013.

and to euro area liquidity facilities. By contrast, Romania in May 2014 announced a timeline for euro accession and highlighted the benefits of banking union membership for its local financial system. With three-quarters of local banking sector assets in the hands of eurozone-based financial institutions, Governor Isarescu pointed out that local supervision no longer seemed sensible, and that coordination with the home supervisors and the SSM would become increasingly complicated. Most recently, the crisis around a number of large banks in Bulgaria also appears to have shifted the debate in that country.

For non-EU countries in the eurozone's immediate periphery clearly the options for cooperation are more limited, though the interests in close collaboration may be equally strong. In Serbia, for instance, six of the eight largest banks are from the eurozone and in total control nearly half of local banking sector assets. For countries outside the European Union credibility and confidentiality of the supervisory bodies may well be in doubt, and access to EU core supervisory colleges is not automatic. Yet there are clearly options to accelerate the convergence with EBA norms.

The SSM regulation offers no additional opening for cooperation with authorities in markets outside the European Union. The ECB may conclude administrative arrangements with these bodies, though no legal obligations shall arise. For some host countries, notably those in Latin America, the cooperation with home supervisors in Europe seems to have worked well, building on mutual trust, well-functioning information flows and a clear division of responsibilities. This well-established cooperation can continue, but in parallel new relations with the ECB as the single supervisor will have to be established. Non-EU host countries seeking close cooperation with the ECB may be well-advised to reduce non-performing assets in their banking systems, for instance by running exercises similar to the ECB's AQRs and the stress tests. Such exercises are likely to become more regular, and methodologies are increasingly standardised. Most countries should be able to obtain assistance from international institutions such as the IMF, or even from the ECB itself.

A country such as Mexico, where two Spanish banks control a third of banking sector assets, will be keen to maintain as close a level of access in information sharing as has been the case to date with its counterparts in the Bank of Spain. Nevertheless, it is likely that the present trends towards more decentralised liquidity and capital management within Spanish bank subsidiaries will continue, and with it the establishment of commensurately assertive local regulations and resolution powers. Elsewhere, host countries have experienced complicated relations with individual eurozone home supervisors and will consider a single supervisor and a single resolution authority a great simplification.

6. Adapting banking union institutions to preserve financial integration

The SSM and SRM represent essential progress in breaking the link between bank and sovereign debt distress within the eurozone. Institutional integration is about to catch up with the extent of financial integration that has been achieved.

Yet clearly there is a risk of a two-speed integration and of an ultimate division of the European Union's single market. The EBA's single rule book of supervision and the resolution procedures in the BRRD offer some degree of uniformity across the single market, though it is hard to imagine that interests of eurozone countries and of the institutions they will run within the ECB and for the SRM would not ultimately dominate.

As suggested in Schoenmaker's (2011) financial trilemma, opting to preserve integration and benefiting from the greater stability offered through the common institutions and the resolution funds will clearly imply a loss of sovereignty. EU governments, both inside the eurozone and outside it, have recently demonstrated a greater proclivity to favouring their national interests in terms of the regulation, taxation and governance requirements imposed on banks**.** Few will be ready to embrace standards set within the ECB, where access to governance mechanisms will remain imperfect.

Arguably, it is in the interests of the eurozone countries and the ECB itself to make the opt-in of other EU countries into the banking union as attractive as possible, but for important new EU member countries such as Poland or Hungary, let alone for Sweden, euro accession remains on hold for the foreseeable future. A first step could be to capitalise on the ongoing asset quality reviews and stress tests. This process will initiate a more rapid NPL recognition, balance sheet clean-up and adequate capitalisation of euro area banks and their subsidiaries. The ECB is committed to a high level of transparency once results are available, though only within the euro area. Non-euro EU members could be encouraged to disclose the results of systemic banks under the supervision of the SSM, and run their own broader stress tests along similar methodologies.

A key issue of contention has also been the provision of euro liquidity, which emerged as a key vulnerability for several central European countries in 2010. Unlike within the remit of the ECB's refinancing instruments, non-euro countries will have to provide liquidity through their national central banks, including in euros. However, additional benefits that replicate the privileges of eurozone members, such as liquidity facilities in the form of foreign exchange swap lines, could again be considered.[28]

The gradual build-up of resolution funds within EU countries as set out in the BRRD, and the ultimate limited mutualisation and conditional back-up through the ESM for SSM members, offers better protection in crisis situations for host countries, both within and outside the European Union. At the same time, the procedures within the SRM could be perceived as cumbersome and hard to decipher. This may complicate crisis management relative to the more informal but predictable relations with individual EU home authorities. Discretion by resolution authorities could give rise to perceptions of differential treatment of creditors and

[28] See the proposals in Berglof et al. (2012).

destabilising cross-border fund flows. The list of liabilities potentially subject to bail-in and the conditions for host country discretion should be further clarified.

As for non-EU host countries, eurozone banks have an extensive, and in many cases systemic, role in a number of emerging markets. Arguably, preserving close integration with these markets is in the ECB's own financial stability mandate. The present stabilisation in eurozone growth prospects and the revival of debt markets in its periphery have mitigated potential contagion risks from eurozone-based parent banks to their emerging market subsidiaries. The prospect of a credible asset quality review, stress tests and more adequate capitalisation is likely to stem further external deleveraging pressures. At the same time, the establishment of the banking union will complicate information exchange between non-EU hosts and the ECB as the new principal home supervisor. For the time being, bank resolution scenarios have become less predictable, and the ECB will have to contend with key emerging market hosts setting up their own parallel procedures and safeguards.

Cooperation with other supervisors will be most effective when agencies share the same principles and have the same or largely similar institutional frameworks. Following a confidentiality agreement with the EBA it should be possible to maintain access to supervision procedures on a level close to that enjoyed to date with individual EU countries. To this end, the ECB's existing technical assistance programmes could be expanded to facilitate an upgrade of central bank capacity, perhaps supported by the EBA for the relevant areas. In the immediate EU neighbourhood the focus could be on countries with the status of EU accession candidates, as for instance in the case of Serbia.

For a small number of large emerging markets outside the European Union there is a trend towards stronger local supervision as defined by independent resolution scenarios. Where information sharing with the SSM and participation in colleges remains unclear, regulatory ring-fencing within host countries is inevitable and will need to be taken into account in the ECB's own supervision and resolution planning. More cooperative strategies should be defined in bank-specific recovery and resolution plans. The plans now being designed for SIFIs, the largest and most complex institutions, could provide an important illustration of the complexities inherent in these scenarios.

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