

Bulgaria and Croatia join the EU's ERM II and establish close-cooperation with the Banking Union

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Quick Take:

While a welcome development for these two EU Member States, offering a range of opportunities, much preparation needs to be done by market participants and supervisors.

- Bulgaria and Croatia join the ERM II from July 10, 2020, for the next two years.
- ERM II central rate for Bulgaria is €1 = BGN1.95583 i.e. at the existing exchange rate, given that Bulgaria is joining ERM II with its existing currency board arrangement in place. For Croatia, the central rate is set at €1 euro = HRK 7.53450. A fluctuation band with a standard range of $\pm 15\%$ around the respective central rates above will apply.
- SSM and SRM supervision begins from October 1, 2020.
- Banking Union Supervised Institutions need to prepare for a very different supervisory tone to what they may be used to, even if full Eurozone and thus Banking Union membership is expected at the earliest in 2023.

Bulgaria and Croatia join the EU's ERM II and establish close-cooperation with the Banking Union

On July 10, 2020, the European Central Bank (**ECB**), acting in both its central banking role and also in its capacity as the head of the Banking Union's Single Supervisory Mechanism (**SSM**) confirmed that Croatia and Bulgaria had joined the SSM and that the Bulgarian lev and the Croatian kuna were being included in the Exchange Rate Mechanism II (**ERM II**). The Single Resolution Board in its role as the head of the Banking Union's "second pillar" i.e., the Single Resolution Mechanism (**SRM**) also confirmed that Bulgaria and Croatia were joining the SRM.¹ The accession of Bulgaria and Croatia to the Eurozone and the Banking Union increases the number of participating Member States to 21 out of the EU-27.²

This Client Alert assesses the impact and opportunities for financial services firms based in these newest EU Member States joining the Banking Union and ERM II, as well as for firms looking to do business in these jurisdictions. While both Bulgaria's and Croatia's economies and specifically the banking sector were already closely linked to the Eurozone, their accession included some additional requirements in terms of far-reaching legislative and institutional reforms set out in "country-specific prior commitments" (**CSPCs**). Both countries have now satisfied these measures in order to participate in ERM II and ultimately adopt the euro by 2023, as well as being permitted to fully operationalize close-cooperation arrangements with Banking Union supervision from October 2020, ahead of full Banking Union membership upon adoption of the euro i.e., at the earliest in 2023.

The idea behind a Member State participating in the Banking Union before adopting the euro is to promptly address potential weaknesses in its domestic banking sector. This, in turn, avoids these weaknesses weighing on the national economy and public finances in the future, with negative spillovers across the entire Eurozone. The start of close cooperation with Banking Union supervision not only builds upon the completion of the respective CSPCs but follows on from completion in late 2019 of a 'Comprehensive Assessment' and an 'Asset Quality Review' of Bulgarian and Croatian banks that are set to become or are already subsidiaries or affiliates of Banking Union Supervised Institutions (**BUSIs**). The ECB-SSM's Comprehensive Assessment and Asset Quality Review were finalized prior to the outbreak of the COVID-19 health crisis and the ECB-SSM notes that the economic and other impacts have not been factored into its findings.

Even if the majority of the banking sector in these two countries are serviced by BUSIs headquartered in the Eurozone, the extension of the SSM's and the SRB's rules along with the respective supervisory expectations, even during the close cooperation phase, will give a very different feel to how such BUSIs' domestic operations, whether Eurozone headquartered or not, have been supervised to date. The accession of both Bulgaria and Croatia is certainly welcome and marks a turning point for each of these countries, as well as the Eurozone and its Banking Union as a whole. Eurozone membership also, however, may mark a change in opportunities but also investor and consumer behavior in these countries.

¹ Available [here](#).

² See also coverage from our Eurozone Hub in respect of Croatian accession available [here](#).

Why join now?

Fifty years have passed since the leaders of what has since become the EU³ first entertained the idea of establishing an economic and monetary union (**EMU**) between all EU Member States a plan that was then supposed to be achieved within only 10 years, but was quickly abandoned in the wake of the 1970s oil crisis⁴. Fast-forwarding to the 21st century and the global financial crisis (**GFC 2008**), the euro project and the EMU were then subjected to another set of tests for cohesion and resilience.

Two decades later the euro has become a tangible sign of the EU's identity, which has accelerated integration and completion of the internal market and notably, in particular since the GFC 2008, the Single Market for financial services. In the global economy's context, this has translated into a stronger presence for the EU, incentivizing many third countries to do business/invest in the EU and/ or to use the euro as a reserve currency⁵ or even as their own national currency⁶. As a result, the Eurozone family continued to grow, with many of the newer Member States joining the family of (now 19⁷) Member States using the euro as their common currency⁸ and also (since 2014) taking part in the Banking Union. This includes, the "newer" Central and Eastern European Member States, with Slovenia becoming the first, when it joined the Eurozone only three years after it became part of the EU.

The Eurozone expansion is not only down to its economic strength. The Maastricht Treaty⁹ makes the adoption of the single currency mandatory for all current and future Member States.¹⁰ Nevertheless, neither the Maastricht Treaty nor any other EU piece of legislation provides for a specific timeline for adopting the euro, leaving it up to the non-Eurozone Member States¹¹ to decide when to convert to the single currency. Some countries quickly met the obligations set forth in the Maastricht Treaty and their respective accession agreements to become members of the Eurozone, whereas others may have been incentivized by their own experiences with devalued currencies and crumbling economies in the 1990s. The GFC 2008 aftermath, however, might also be the reason why some of those newer EU Member States, such as the Czech Republic, Hungary and Poland, have not taken active steps towards joining the Eurozone family.

It is safe to say that there is a complex mix of socio-economic reasons why some jurisdictions (as well as respective governments) are more active in their Eurozone accession plans than others. For instance, surveys have suggested that the Swedish rejection of the euro reflects the country's perception of the EU itself rather than a general disapproval of the Eurozone. While this may be understandable coming from a country that is a net contributor to the EU budget¹², smaller and arguably weaker economies, such as Bulgaria or Croatia¹³, have reaped the

3 At the time referred to as the European Community, comprised of the six founding member states – Belgium, France, Germany, Italy, Luxembourg and the Netherlands. For further information see [here](#).

4 In 1970, a high-level group, chaired by the then Luxembourg Prime Minister Pierre Werner, produced a report laying out a plan how to achieve this goal within only 10 years. The Werner Plan came about after a period of economic growth and was abandoned with the oil crisis of 1973.

5 See European Commission. *The benefits of the euro* available [here](#).

6 Notably Andorra, Monaco, San Marino and the Vatican City have all adopted the euro as their national currency, via specific monetary agreements with the EU, despite the fact that they are not EU member states. For further see European Commission. *What is the euro area?* available [here](#).

7 All EU members are members of the EMU, but only 19 of them have also replaced their national currencies with the euro. These EU countries form the euro area/ the Eurozone and include Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain. For further information see [here](#).

8 Slovenia joined the euro on 1 January 2007 and became the first of the 10 countries that joined the EU on 1 May 2004 to adopt the euro. Cyprus and Malta both joined the Eurozone in 2008 and Slovakia joined in 2009. The Baltic countries – Estonia, Latvia and Lithuania joined in 2011, 2014 and 2015 respectively. For further information, see [here](#).

9 The Treaty on European Union (the Maastricht Treaty), which was adopted on 7 February 1992 (OJ C 326, 26.10.2012), created the EU and, inter alia, laid the foundations of the modern day EMU, the single currency (the euro) and the criteria for its use (including the introduction of the European Central Bank). It also made the adoption of the euro mandatory for all current and future members of the EU, except for Denmark and, the then EU member, United Kingdom, as both countries had negotiated opt-outs.

10 Except for Denmark and, the then EU member, United Kingdom. For further see European Commission. *What is the euro area?*

11 There are seven non-Eurozone EU member states: Bulgaria, Croatia, the Czech Republic, Hungary, Poland, Romania, Sweden and 1 non-euro state with an opt-out: Denmark. For further see *Ibid*.

12 As per the latest data available, the total contribution of Sweden to the EU budget equals €3.3 billion, while the total EU funding in Sweden equals €1.8 billion. For further information see [here](#).

13 As per the latest data available, Bulgaria has the lowest level of GDP per capita in the EU. For further information see [here](#).



positives of a strong euro. Both countries have been vocal about joining the Banking Union¹⁴ and the Eurozone not least because the main trading partners of both countries are Eurozone Member States and their domestic banking sectors are dominated by Eurozone-headquartered banks.

Despite the EU positivism, however, the EU-project is now faced with another crisis – the **COVID-19 crisis** – which is not only putting the euro to the test, but also has strained cohesion and solidarity in the Union. In this time of financial and regulatory uncertainty both Bulgaria and Croatia have found themselves in a situation where they had already made significant steps towards meeting their obligations to join the Eurozone, but where the challenging road to the single currency had become ever more difficult, including in respect of Croatia a devastating earthquake which caused significant economic damage. This of course is an issue in its own right but presents a potential problem for Croatia's compliance with the Maastricht Criteria, given its high debt-to-GDP ratio and overshooting GDP deficit. Only if Croatia shows a credible trend of contraction in debt to GDP and other criteria are fulfilled, will

full euro membership be achieved. In Bulgaria the relatively low price level suggests, as the European Commission has set out in its Convergence Report, "significant potential for price-level convergence in the long term", which may cause a rise in inflation that poses an obstacle to Maastricht Criteria compliance. All rating agencies consider the ERM II and ultimately the euro adoption process as positive and while COVID-19 has put upgrades for these countries on hold, the positive outlooks for both countries will likely translate into upgrades.¹⁵

One of the main arguments used by euro opponents outside but also within both Bulgaria and Croatia has been the cost-sharing principle of the Eurozone– i.e. the principle that stronger economies bear the cost of having weaker Eurozone Member States, in order to ensure that the euro remains a strong and stable currency to the benefit of all Eurogroup countries. Notably, this has been a hot topic of discussion after GFC 2008 and more recently with the so-called "corona-bonds" debate, where imbalances between the Eurozone Member States has become more apparent. On the other hand, not being part of the Eurozone would mean that Bulgaria and Croatia would not have access to the ECB's extraordinary support measures, including the €1,350 billion Pandemic Emergency Purchase Programme (PEPP)¹⁶ or other Eurozone funding options that might be critical for the economy during the COVID-19 crisis and in driving economic recovery, including not having access to the resolve of the ECB "to do whatever it takes to preserve the euro"¹⁷.

- 14 Banking Union - the need for a Banking Union emerged as a response to the GFC 2008, and is an important step to having a complete EMU. It provides for common policies within the banking sector for Eurozone countries and other non-euro member states that choose to participate. The Banking Union consist of three pillars with the first two already in place – the SSM and the SRM; the third pillar – the common deposit scheme (EDIS) is not yet fully in place, however. For further background see [here](#).
- 15 Moody's is the only rating agency that has kept Bulgaria (Baa2) and Croatia (Ba2) on a positive outlook. Moody's had expected ERM II entry to be pushed back to 2021 due to the ongoing crisis and thus the start could result in an upgrade in particular if more positives could eventually come from the planned EU Recovery Fund (the initial proposal indicated c. EUR12bn and EUR10bn for Bulgaria and Croatia, respectively). S&P looks less inclined to upgrade which has moved the outlook on Bulgaria's BBB rating back to stable at the end of May 2020. For both Bulgaria and Croatia, S&P expects to see an improving growth outlook or, in the case of Bulgaria, a strong external performance. S&P applies a heavy penalty for Bulgaria's monetary assessment given the currency board regime while ERM II is seen as strengthening monetary credibility over time. Fitch has outlined a process for the rating implications of the euro adoption process in August 2019, expecting an upgrade if a country is formally admitted into ERM II (and if it is short and euro adoption is credible), followed by another upgrade once a country gets the green light to formally adopt the euro. In the case of Croatia, Fitch has voiced some concerns on fulfilling the euro-convergence criteria, notably on high public debt. This might make an upgrade of Bulgaria more likely while there is a chance that Croatia's BBB- rating only moves to a positive outlook.
- 16 All Eurozone members, unlike Bulgaria, will have access to the ECB's new and original €750 billion since increased to €1,350 billion temporary asset purchase program of private and public sector securities. For further information regarding the PEPP see [here](#).
- 17 This famous statement was made by Mario Draghi, the former President of the ECB at the Global Investment Conference in London on 26 July 2012. A full transcript of the speech can be found [here](#). In many ways COVID-19 and the PEPP response has turned into President Lagarde's "whatever it takes" moment.

The journey to ERM II and beyond

An EU member state is required to participate in ERM II for at least two years and satisfy the 'Maastricht' or Convergence Criteria prior to adopting the euro¹⁸. Regular updates on progress are published at least every two years by the ECB and the European Commission in their respective Convergence Reports.¹⁹ One key difference with the 2020 Bulgaria and Croatian accession, certainly when compared to previous ERM II and ultimately Eurozone accessions, was that these new applicant countries had to, prior to being admitted to ERM II and Banking Union supervision, satisfy the CSPCs and subsequently similar Post-Entry Commitments (**PECs**), thus creating what is being referred to as "Convergence+ Criteria".

The CSPCs' prerequisites were designed (in part) based on previous accession experiences²⁰. They aim to improve the Member States' participation in ERM II and their transition to close cooperation and ultimately full Banking Union (i.e., SSM and SRM) supervision. The CSPCs required that both countries undertake and show efforts to improve national law measures. These include ongoing efforts in strengthening or accelerating compliance with EU law requirements, targeted legislative measures and institutional improvements relating to structural policies, strengthening the macro-prudential toolkit, notably through granting NCAs binding powers to introduce borrower-based measures which inter alia include limits to loan-to-value (LTV), loan-to-income (LTI), debt-service-to-income (DSTI) ratios, maturity limits and loan amortization requirements. The CSPCs also required full compliance in transposing the EU's anti-money laundering framework into national legislation. These general requirements were also supplemented by the following country-specific measures:

- for Bulgaria, this included enhancing non-banking supervision, improving the insolvency framework and strengthening the governance of state-owned enterprises;

- for Croatia, this included reforming the collection and production of national statistics, enhancing public sector governance and reducing the administrative and financial burden.

The ECB undertook an assessment of the ERM II CSPCs as they relate to the strengthening of the macroprudential toolkit. The ECB's conclusions are set out in the following key documents published on July 10, 2020, which also cross-refer to the PECs that both Bulgaria and Croatia will abide by:

- With respect to Bulgaria:
 - ECB Assessment Report on completion of the commitments made by the Republic of Bulgaria on the macroprudential toolkit (the **ECB Bulgarian Report**)²¹; and
 - an ECB "Communiqué"²² detailing acknowledgement of the PECs that the Bulgarian authorities will pursue, notably on sound economic policies, economic and financial stability and sustainable convergence, as well as the PECs. These include an undertaking to implement specific policy measures on the non-banking financial sector, state-owned enterprises, the insolvency framework, and the anti-money laundering framework. Bulgaria will also continue implementing the extensive reforms carried out in the judiciary and in the fight against corruption and organized crime in Bulgaria, in light of their importance for the stability and the integrity of the financial system. The Bulgarian PECs themselves are set out in the Bulgarian authorities' application letter²³ appended to the Communiqué.

18 See Art. 140 of the Treaty on the Functioning of the European Union (TFEU) - the convergence criteria measure the progress of the non-euro member states and their preparedness to adopt the single currency based on a set of macroeconomic indicators. Every two years a new review is performed.

19 An overview of which is available [here](#), with the most recent ECB report (June 2020) available [here](#) and the European Commission (June 2020) one available [here](#).

20 Estonia, Lithuania and Slovenia joined ERM II in 2004; Cyprus, Latvia, Malta and Slovakia joined ERM II in 2005.

21 Available [here](#).

22 Available [here](#).

23 Available [here](#).

- With respect to Croatia:
 - ECB Assessment Report on completion of the commitments made by the Republic of Croatia on the macroprudential toolkit (the **ECB Croatian Report**)²⁴; and
 - an ECB “Communiqué”²⁵ detailing acknowledgement of the PECs that the Croatian authorities will pursue, notably on sound economic policies preserving economic and financial stability and sustainable convergence, as well as to implement specific policy measures on the anti-money laundering framework, the business environment, state-owned enterprises and the insolvency framework. The Croatian PECs themselves are set out in the Croatian authorities’ application letter²⁶ appended to the Communiqué.

The European Commission on July 10, 2020, provided its confirmation that the CPSCs, including in terms of items other than those assessed by the ECB(-SSM), had been fulfilled. These were set out in:

- a Letter by Executive-Vice President Dombrovskis and Commissioner Gentiloni to ERM II parties on Bulgaria (the **Commission’s Bulgarian Assessment Letter**)²⁷; and
- a Letter by Executive-Vice President Dombrovskis and Commissioner Gentiloni to ERM II parties on Croatia (the **Commission’s Croatian Assessment Letter**)²⁸.

It is quite conceivable that CSPCs will feature as a tool for review of the suitability of any future accession candidates to ERM II and the Banking Union. In many ways, this adds a “waiting room” to the Banking Union on top of the existing waiting room in the form of the ERM II’s transition period prior to Eurozone membership. Consequently, the Bulgarian and Croatian reviews provide an insight into both what and how any future applicants might need to



consider and what those assessing compliance look at and with what scrutiny.

How ERM II operates and what it means for currencies

ERM II was introduced in 1999 as one of the ways to assess an EU member state’s convergence with that of the Eurozone. Bulgaria (and the lev) and Croatia (and the kuna) in joining the ERM II will join the list of other EU Member States that have transitioned to full Eurozone membership and Banking Union participation.

The ECB, in its central banking role and notably through the General Council²⁹, monitors ERM II countries’ compliance and decides when to take “intervention mechanisms” with the ERM II Member States’ central banks i.e. to stabilize the currency within the permitted bands of the ERM II rate. The General Council, together with the European Commission, assesses periodically, based on “Convergence Reports” and ultimately at the earliest at the end of the minimum two-year assessment period, whether an applicant’s participation in ERM II has been evaluated as sustainable and thus whether it should progress from the ERM II mechanism to Eurozone membership.

The ERM II mechanism not only enables exchange rates between the non-euro area member state’s currency and the euro to be managed, it also, and most importantly, is a way to test the sustainability of convergence before and after euro adoption.

24 Available [here](#).

25 Available [here](#).

26 Available [here](#).

27 Available [here](#).

28 Available [here](#).

29 Comprised of the governors of Eurozone and non-Eurozone central banks.

The ECB has applied some of the lessons learned from the previous ERM II to Eurozone transitions and this marks the first time they are being applied to what are the EU's newest Member States, with Bulgaria having joined in 2007 and Croatia having joined the EU in 2013.³⁰

The main general features of ERM II are:

- i. a central exchange rate against the euro as calculated on July 13, 2020, on the opening of foreign exchange markets. In the case of:
 - a. Bulgaria this is set at €1 = BGN1.95583 i.e. at the existing exchange rate given that Bulgaria is joining ERM II with its existing currency board arrangement³¹ in place³²;
 - b. Croatia this is set at €1 = HRK7.53450;
- ii. a fluctuation band with a standard range of ±15% around the respective central rate above;
- iii. central bank interventions at the margins of the agreed fluctuation band;
- iv. the availability of very short-term financing from participating national central banks. The participating national central banks can, however, unilaterally commit to tighter exchange rate regimes than those provided for by ERM II, without imposing any additional obligations on the ECB. This is now the case with Bulgaria, which has joined ERM II with its currency board, as Estonia and Lithuania did in the past.

30 In introductory remarks by Fabio Panetta, Member of the Executive Board of the ECB, at a meeting of the Euro Accession Countries Working Group of the Committee on Economic and Monetary Affairs of the European Parliament published July 13, 2020 (available [here](#)), Panetta states: "It became clear that participating in ERM II alters the economic incentives of international and local investors as well as those of the authorities of the participating countries. Evidence suggests, in particular, that after a country joins ERM II, it may experience large and volatile short-term capital inflows. Especially if coupled with a weak institutional set-up, this may set the wrong incentives, leading to the postponement of necessary reforms and a deterioration in the country's adjustment capacity. We have learned lessons from the financial crisis related to sustainable convergence that have led to reforms in the architecture of Economic and Monetary Union, such as the establishment of the Banking Union. These lessons were taken into account when designing the path of Bulgaria and Croatia towards ERM II." This includes the country-specific prior commitments."

31 A comparison can also be drawn between Bulgaria and another two EU member states with a similar past – Estonia and Lithuania. The Baltic States were included in the ERM II a couple of months after their EU accession in 2004. Despite their speedy inclusion, however, it took another six years for the Council of the EU to approve Estonia's accession to the Eurozone and a total of 10 years for Lithuania, making the latter the newest Eurozone member at present.

One takeaway from the two Baltic countries' experience, which resonates with the concurring applications of Bulgaria and Croatia, is that other than the member states that were part of the original "big bang" adoption of the euro in 1999, no two EU member states would have the same path to the Eurozone, even if one may see a large number of similarities between them. Another takeaway, however, is that joining the ERM II is not only a matter of technically fulfilling criterion 3 of the convergence criteria, but also a number of "other" measures, including what an EU Commission Executive Vice President has described as "practical preparations" as part and parcel of Bulgaria's future ERM II membership. Some central bankers have even suggested that joining the ERM II in the first years following the introduction of the euro may have been a lot easier, as this was pre-GFC 2008, and that the situation has rapidly changed, making the process particularly difficult for the newer member states that, like Bulgaria, may attempt to join the Eurozone today. This is particularly important when considering the key commonality between Estonia, Lithuania and Bulgaria – the currency board.

Currency boards have been around for a couple of hundred years now, with the first one being introduced in 19th century Mauritius. They normally tend to occur at turbulent times with great currency instabilities, where an exchange rate arrangement (the currency board) is put in place for the purpose of a centralized authority to be able, at any given point in time, exchange the local currency for another – the anchor currency, at a pre-defined fixed exchange rate. The currency boards in Lithuania and Estonia were introduced in the early 1990s after both countries exited the ruble zone in a bid to stabilize and manage their emerging economies. Bulgaria, although not part of the Soviet Union and the ruble zone, also faced difficulties with its economic transition, which led to a banking crisis and a 2000% inflation by the spring of 1997. Consequently, the International Monetary Fund (IMF) had to approve a US\$582 million 20-month stand-by credit for Bulgaria in the form of an economic program, aiming to restore macroeconomic stability, facilitate long-delayed structural reforms and stabilize the economy. The IMF also initiated the introduction of a currency board that, after costly delays and opposition and much debate – on issues ranging from the selection of the anchor currency (US Dollar vs Deutsche Mark), the lack of currency board success stories under similar conditions, to a potential large up-front devaluation, etc., was finally put in place with the adoption of the Bulgarian National Bank Act (BNB Act) in the summer of 1997.

The BNB Act statutorily pegged the Bulgarian lev to the Deutsche Mark (BGL 1= DM 1), but only until the euro was to become the legal tender of the Federal Republic of Germany, after which the lev was to be pegged to the euro at a rate dependent on the official DM to euro exchange rate. Following the euro's introduction in 1999 and the Bulgarian lev redenomination (BGL 1= BGN 1), the BNB set the Bulgarian lev peg to the euro at €1 = BGN 1.95583 – an exchange rate that has been observed ever since.

It should be noted that although the currency board provided much-needed trust in the banking sector, it also limited some of the classic central bank functions of the BNB, notably in the field of monetary policy, and if this may not have been so important in 1997, it is critical in the current crisis, as this may hinder the BNB's response to potential financial shocks. Most notably, as with other ESCB participants, the BNB is legally barred from extending any credits to financial institutions, except for some very specific exceptions related to short-term liquidity issues that a viable bank may experience. Even in situations where the BNB is permitted to provide support, it is under a general obligation to refrain from incurring liabilities in excess of the lev equivalence of the foreign exchange reserves (i.e. the reserve managed by the BNB's Issue Department as part of the currency board should always be greater than the overall liabilities of the central bank).

32 Bulgaria has been very open about its euro ambitions, but it has also maintained its currency board for the past 20+ years. The importance of the currency board arrangement may be unappreciated by existing Eurozone members, but some equated it to a religion. So much so that the Bulgarian government had been mandated to withdraw from the Eurozone negotiations should the current lev - euro fixed exchange rate not be accepted as the set conversion rate.



How the transition from close-cooperation to full Banking Union supervision will impact Bulgaria and Croatia

The ECB-SSM and the SRB require that any EU member state requesting close-cooperation with the Banking Union adopt legislation that allows the Banking Union authorities to carry out their respective supervisory tasks. The banking sector in the member state also has to undergo a Comprehensive Assessment and an Asset Quality Review (which includes a stress test) (the **CA+AQR**) in addition to the Banking Union authorities requesting information from or providing technical support to the relevant requesting national competent authorities (**NCA**s).

The CA+AQR is a prudential exercise, rather than an accounting exercise, and provides the ECB-SSM with a point-in-time assessment of the value of banks' assets on a particular date i.e., usually the latest year-end. The

CA+AQR also determines whether there is a need to strengthen a BUSI's regulatory capital base. The CA+AQR for the Bulgarian and Croatian banks was carried out on the basis of the ECB's updated AQR methodology, which was published in June 2018³³ and takes account of the impact of accounting standard IFRS 9.

Following the establishment of close-cooperation, Bulgaria and Croatia will, from October 1, 2020, participate in the SSM with the same rights, with small amendments³⁴, as those existing full participating Member States. This means that the ECB will in the context of the SSM directly supervise (and the respective NCAs will indirectly supervise) those BUSIs that are for Banking Union purposes categorized as Significant Credit Institutions (**SCIs**)³⁵

33 Available [here](#).

34 This includes the following differences during close cooperation:

- the ECB-SSM will not adopt decisions addressed to BUSIs in the member state concerned, but rather instructions addressed to the NCA, which will in turn adopt the required national administrative measures addressed to BUSIs; and
- the member state in close cooperation is not represented in the Governing Council. For this reason, a special procedure allows the NCA in close cooperation to express disagreement with the Supervisory Board's draft decisions and with any objections by the Governing Council to those draft decisions. If no agreement is reached, the member state may opt to terminate close cooperation.

35 The significance criteria that a bank needs to meet, in order to become subject to the ECB's direct supervision is:

1. Size: the total value of its assets exceeds €30 billion; or
2. Economic importance: for the specific country or the EU economy as a whole; or
3. Cross-border activities: the total value of its assets exceeds €5 billion and the ratio of its cross-border assets/liabilities in more than one other participating member state to its total assets/liabilities is above 20%; or
4. Direct public financial assistance: it has requested or received funding from the European Stability Mechanism or the European Financial Stability Facility.



and for those BUSIs that are categorized as Less Significant Institutions (**LSIs**) the NCAs will directly supervise those (and the ECB-SSM will indirectly supervise) such entities. Further changes to the way investment firms are regulated for prudential regulatory purposes³⁶, as well as pending changes to the supervision of financial holding companies and other structures³⁷, may mean that other firms that do not presently qualify as BUSIs may become subject to ECB-SSM and thus Banking Union supervision both in terms of rulemaking and supervisory expectations.

The SRB will, from October 1, 2020, become the resolution authority for SCIs and cross-border groups and will oversee resolution planning for LSIs. The NCAs of Bulgaria and Croatia will, in their role as national resolution authorities, have representatives in the SRB's Plenary Session and Extended Executive Sessions with the same rights and obligations as all other members, including voting rights. BUSIs and some investment firms will contribute to the SRB's Single Resolution Fund, which supports resolutions.

In the context of the Bulgarian CA+AQR, which was completed in July 2019³⁸, using December 2018 figures, the ECB-SSM reviewed six Bulgarian banks, including local operating units of Banking Union

headquartered BUSIs, which will become SCIs and will thus be directly supervised by the ECB-SSM. Four of the six Bulgarian banks were found to not face regulatory capital shortfalls. The remaining two have since been subject of measures to strengthen their resilience. Despite the fact that Bulgaria currently does not have any banks that fulfil the significance criteria, the ECB-SSM will most likely exercise its right to directly supervise the three most significant Bulgarian credit institutions³⁹ and thus Joint Supervisory Teams (**JSTs**) including the BNB would need to be created⁴⁰.

In the terms of the Croatian CA+AQR, which was completed in June 2020⁴¹, i.e., during the midst of the COVID-19 lockdown measures and a devastating earthquake but using June 2019 figures, the ECB-SSM concluded that the five Croatian banks had all passed the CA+AQR with no remedial measures needed to improve their regulatory capital position. Even if the CA+AQR does not review conduct of business failings, criticism has been expressed that the ECB-SSM did not consider the fact that one of the leading Croatian banks, a subsidiary of a major Eurozone headquartered SCI, was under investigation by the Croatian NCA for alleged suspicious transactions and breaches of anti-money laundering and financial crime rules.

36 See the most recent coverage in our dedicated series on the EU's Investment Firms Regulation and Investment Firms Directive available [here](#).

37 See the most recent coverage in our dedicated series on the EU's changes to the CRR/CRD IV Framework available [here](#).

38 Details of which are available [here](#).

39 Art. 6 para.4 SSM Regulation provides that the ECB shall supervise the three most significant institutions in each euro MS and each non-euro MS with which the ECB has established close cooperation, unless specific circumstances dictate otherwise.

40 See Part IX of Regulation (EU) 468/2014 of the European Central Bank establishing the framework for Mechanism between the European Central Bank and national competent authorities and with national designated authorities (the **SSM Framework Regulation**) (OJ L 141, 14.05.2014).

41 Details of which are available [here](#).



Participating but with limits

There are number of challenges that would put the close cooperation framework to the test. For one, the close cooperation framework does not grant access to ECB liquidity – i.e. the Bulgarian and Croatian BUSIs would need to comply with the various ECB decisions and instructions, but would not be able to benefit from any financial stimulus, such as the PEPP, that might be the underlying reason for these policies.

More importantly, even if the respective NCAs were not to implement a specific ECB-SSM decision, for instance due to the fact that it has no impact on the country in the context of close cooperation, Bulgaria would indirectly follow the ECB monetary policy without necessarily benefiting from it, due to the euro-lev peg. This is compounded by the issue on representation within the SSM. Member States which have established close cooperation are not represented in the ECB Governing Council. Consequently, while they do have passive engagement they have only very limited ability to influence ECB (supervisory but also monetary policy) decisions that are binding on them⁴², their economies and financial supervision.

A change in supervisory tone

A more immediate impact for the Bulgarian and Croatian financial services sector as well as the Bulgarian/Croatian NCAs is the need to accommodate the supervisory rules and cultural changes that the Banking Union and the ERM II bring. From the perspective of the NCAs this means that they might need to revise their own supervisory methodologies and overall “supervisory style” in order to fit within the SSM/SRM frameworks. For example, the ECB’s supervisory toolkit includes a range of on-site inspections and supervisory outcomes such as recommendations, requirements, limits, findings, follow-up letters, formal decisions, etc.⁴³ The Bulgarian/Croatian NCAs would not need to adopt all of those tools within their own frameworks, but would need to be able to adopt the appropriate supervisory measures on the ECB’s request. In practice this may lead to discrepancies if the national framework cannot accommodate some requests or guidelines e.g. the respective NCAs does not issue findings in the manner that the ECB does and thus it might not even have the process and/or know-how to track the findings’ remediation processes. A similar issue applies in relation to quite detailed rules and supervisory expectations that apply to how BUSIs manage non-performing loans and exposures (NPLs).

42 In essence Art.7 SSM Regulation and Art. 118 SSM Framework Regulation provide member states participating in close cooperation with the right to terminate the arrangement, should there be a disagreement relating to a Supervisory Board’s draft decision.

43 See coverage from our Eurozone Hub on the ECB-SSM’s Guide to Onsite Inspections and Internal Model Investigations available [here](#).

Furthermore, the Bulgarian/Croatian NCAs will need to start interacting more frequently with the Joint Supervisory Teams (**JSTs**) which will be assigned to the SCIs that will fall within the ECB-SSM's direct supervisory remit. As the JSTs are comprised by nationals of all Banking Union Member States working for the various NCAs and the ECB, the Bulgarian/Croatian NCAs would need to be prepared to: (i) interact and work with them; and (ii) provide them with support (incl. staffing) where required. Subsequently, the Bulgarian/Croatian NCAs might need to consider whether there are currently internal needs for re-training staff on various matters (e.g. from addressing language needs to supervisory methodologies, etc.) and whether they have the process and policies in place to accommodate the technical (e.g. use of data rooms during inspections) and/or day-to-day interactions with the other SSM NCAs.

Consequently, many BUSIs, and maybe even supervisors, will need to undergo massive "change the bank" initiatives, in order to ensure that they are close cooperation / euro-ready. These changes would span from corporate governance revisions, process and policies implementations, to major IT overhauls – most notably in the reporting and issue management space, as the ECB-SSM supervisory toolkit includes various mechanisms for providing supervisory feedback that require timely reactions (e.g. on-site inspection reports can include a number of findings with various severities, ECB-SSM supervisory decisions may mandate various initiatives, investigations can include the submission of multiple reports per day, etc.,).

From the perspective of the BUSIs the changes would be even greater, not just for SCIs but also for those LSIs that would remain under the Bulgarian/Croatian NCAs' remits and a differing level of supervisory scrutiny. Most notably, BUSIs would need to start provisioning for the costs of the SSM and the SRM, particularly the supervisory fees and the SRF contributions. In addition, banks would also need to revise their internal processes and ensure that they are able to accommodate any information requests, reviews and/ or supervisory requirements. For the credit institutions that the ECB will supervise directly,

this also means that they would need to implement (or revise, if already in place) a comprehensive findings management system (both in terms of process and technology) to be able to take action on their supervisory to-dos.

Similarly, for the Bulgarian/Croatian NCAs, BUSIs will also need to consider their overall internal set-up and ability to interact with international supervisors. This is particularly the case when considering that the JST Coordinator is traditionally not from the same nationality as the supervised bank (i.e. it is unlikely that a directly supervised bank in Croatia would have a JST headed by a Croatian), unless specific arrangements are made and the banks choose Croatian/ Bulgarian as their "supervisory language". This might sound an easy solution, but as both the supervisors and the supervised would need to follow the ECB's guidelines and processes the need to be accustomed to the rules and procedures remains. For instance, the functioning of the JSTs could prove to be somewhat difficult in terms of language, notably in respect of Bulgarian. As two of the three largest credit institutions in Bulgaria are part of ECB-supervised groups anyway, it is unlikely that any JST communications would be conducted in Bulgarian for instance. However this still begs the question whether these banks, as well as the Bulgarian NCA, have the technical and human resources to be subjected to day-to-day supervision done in English for instance; notably this would also include all written communication and documentation, as well as meetings. To complicate matters further, the second largest credit institution in Bulgaria is part of a non-Eurozone Hungarian domiciled group and therefore, supervisory convergence would need to be achieved not only between the ECB and the Bulgarian but also with the Hungarian authorities, at least from the OTP Group's perspective. In practice, this may be more challenging for the supervisors than the credit institutions, as it is safe to assume that they are already subjected to group-wide policies and procedures that may or may not be in Bulgarian or in Croatian.



BUSIs in Bulgaria and Croatia will want to use the time ahead of October 2020 and ultimately ahead of 2023 to prepare. This includes:

- Performing gap analysis on “strategic steering” in local operating/business units versus how to move to a “Banking Union ready” Target Operating Model (**TOM**), as well as legacy and new transactions (ECB supervisory expectations on new product/transaction approval processes). Simply rolling out Banking Union TOM to a local jurisdiction will be unlikely to work or be accepted by the ECB-SSM let alone the SRB;
- Reviewing the extent and depth of NPLs and beginning to shadow EU + ECB NPL rules, both on a portfolio basis as well as for work-out units earmarking NPLs to priority buckets while embedding ECB-SSM and EU NPL supervisory expectations on policies and procedures;
- Reviewing and amending lending standards (internal policies and procedures as well as client-facing agreements – lending and security) and document justifications for decisions as to how this meets risk appetite, the risk and controls framework (at origination and through lifetime), quality control of the **Risk Appetite Framework** and **Risk Appetite Statements**, as well as overall culture and business model sustainability, including mitigants, which may include implementation testing and covert dry-runs of credit models, rules and origination processes;
- Assessing the suitability and adequacy of management information presented to governance, risk and control functions as well as executive functions to ensure compliance with the Risk Appetite Framework, reporting requirements and overall strategic steering;
- Forward-planning for further AQR and on-site inspections and internal model investigations in a similar fashion to the above as well as specifically the use of models for credit risk related exposures to medium/large corporates, financial institutions and “specialized lending” – which may also include certain structured finance transactions and/or funding lines in certain (perceived) “niche” markets;
- Preparing, with counsel, to implement the ECB SSM’s finalized guides on ICAAP and ILAAP (see our Eurozone Hub’s dedicated coverage on this development), including specific reviews of policies and procedures on determination of Pillar 2 Own Funds Requirement(s) as well as liquidity risk management;
- Certain BUSIs may wish to assess the adequacy of documented and undocumented arrangements providing standby capital and liquidity in the event of shock and how this is reflected (including by reference to ICAAP and ILAAP and/or recovery and resolution planning as well as SSM and non-SSM run SREP-related supervisory dialogue; and
- Updating recovery and resolution planning arrangements as well as MREL eligible financial instruments – including role and location of Intermediate Parent Undertakings.

Outlook

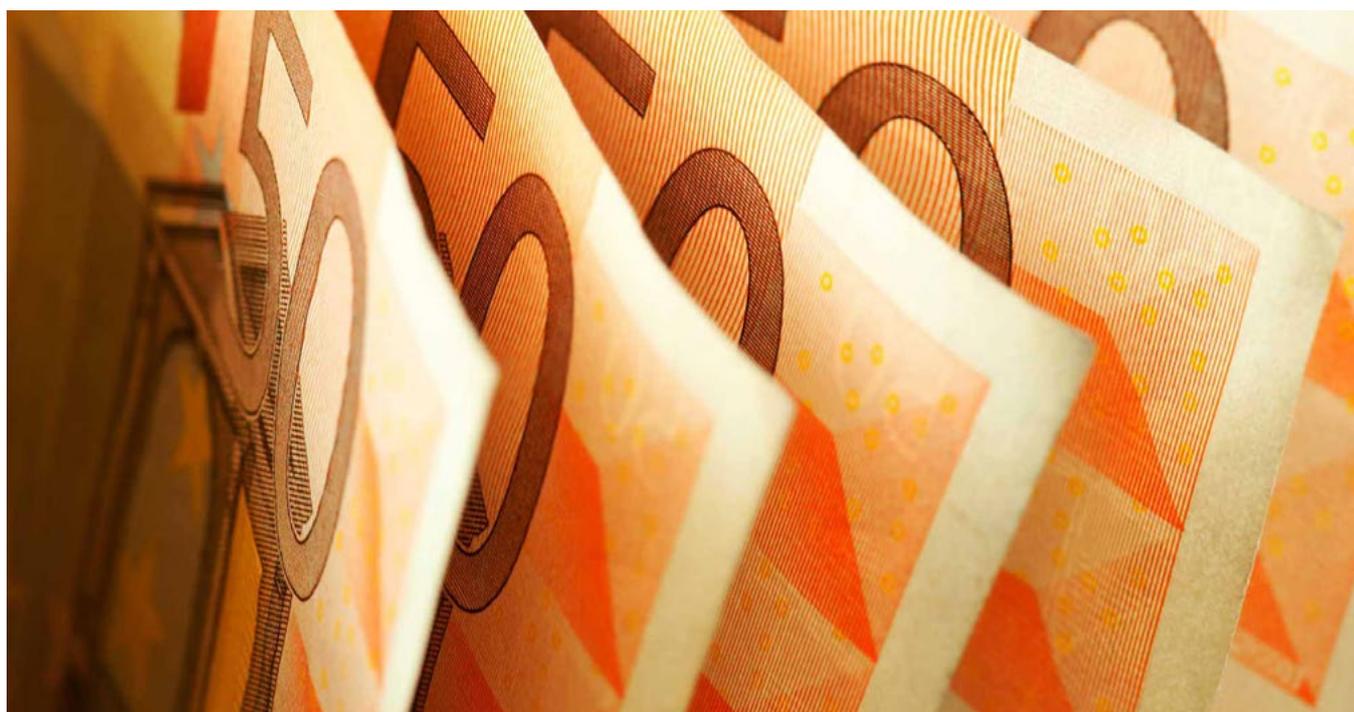
Crucially, the main purpose of the close cooperation arrangement is to pave the road to the euro, but it equally, perhaps more fundamentally, implies a change in the supervisory and resolution framework of the non-euro Member States. Notably, this may be seen as a positive step in the Bulgarian/Croatian supervisory culture, considering that the Bulgarian/Croatian NCAs currently do not perform annual stress tests nor carry on-site and off-site supervision activities that can be compared to the ECB-SSM ones. Furthermore, the supervisory outcomes have rarely been communicated in ECB-comparable “findings” form.

Despite the fact that the changes above may seem challenging, and perhaps costly, at first, improving the supervisory culture in Bulgaria and Croatia is fundamental for a number of reasons. Firstly, it will expose both regulators and BUSIs to supervisory questions that they have not faced before, and over time they will accumulate more experience and this will eventually lead to more efficient processes. Secondly, it will address some of the corruption concerns in the AML space, for strong supervisions and control functions limit AML-/compliance risks in the banking sector, which in turn can result in resolving many of the CPSC and PEC-related commitments and ultimately the remaining ERM

II concerns. Thirdly, intensified supervision may reassure investors and therefore improve the overall investment environment in Bulgaria and Croatia. Fourthly, the public perception in particular in Bulgaria with respect to the currency board may shift from fearing the regulatory and economic outlook to feeling confident in a system where the Bulgarian and Croatian NCAs work closely with the ECB within the close cooperation arrangement and eventually as part of the Eurozone.

If you would like to discuss strategic options or any of the items mentioned above, in particular how to plan ahead for any operational impact from meeting compliance requirements and/or documentation or how these priorities may affect your business or your clients more generally, please contact our Eurozone Hub and further key contacts.

Our Eurozone Hub team operates on a multijurisdictional and multilingual level. It includes bilingual native speakers of Central and South Eastern European languages, including Croatian and Bulgarian and we have experience in assisting on Banking Union “readiness projects” and multi-jurisdictional regulatory reform projects across the region.



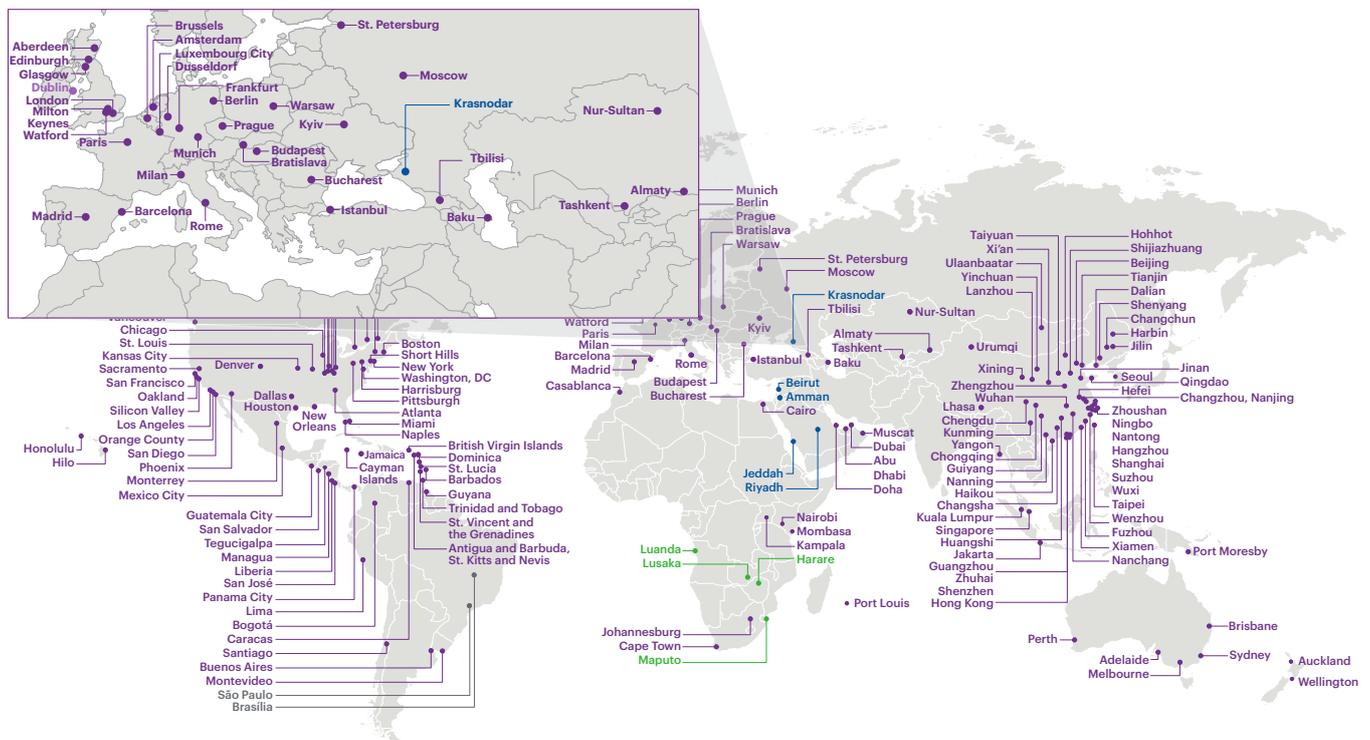
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Eurozone Hub: what we do and how we can help you

Our **Eurozone Hub** can deliver value to you by solving regulatory issues and using regulation to your advantage. Our team operates on a multijurisdictional and multilingual level. It includes bilingual native speakers of Central and South Eastern European languages, including Croatian and Bulgarian and we have experience in assisting on Banking Union “readiness projects” across the region.

We cover all regulatory topics at the EU and at national levels as well as across all sectoral rulebooks.

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