

Croatia's accession to the European Banking Union

- The outlook ahead

August 2019

On July 8, 2019, the Member States of the exchange rate mechanism (**ERM-II**) discussed Croatia's accession to the monetary union within the framework of the Eurogroup. The Croatian Finance Minister and the head of the Croatian National Bank (Hrvatska Narodna Banka – (**HNB**)) set out the details in a letter of intent sent to the Eurogroup, the European Central Bank (**ECB**) and the finance ministers of the Eurozone. This is a very welcome step for one of the EU's most recent Member States and Dentons' **Eurozone Hub**, together with Croatian local counsel firms, are here to support.

Croatia plans to join the ERM-II and the Banking Union in mid-2020 in order to become a full member of the Eurozone as early as 2024. In addition to progress in fulfilling the Maastricht criteria, such as a stable exchange rate and the requirements of the Banking Union, the letter also addresses further voluntary commitments such as the positive development of the country's current account balance and unemployment rate. An action plan in the letter sets out the next planned measures to be implemented by Croatia as part of its planned ERM-II and Banking Union accession.

These include measures in the areas of banking supervision and cooperation with the ECB as well as further legal adjustments set out in the amendment act.

In response, the ECB published their Opinion on what was then a draft law on amendments to the Law on Credit Institutions (the **Amending Act**) which was passed by the Croatian Parliament on July 12, 2019 entering into force on August 1. On August 7, the ECB confirmed that it would launch a Comprehensive Assessment comprised of an asset quality review (**AQR**) and a stress test of five Croatian Banks in September 2019 with results published in May 2020. Those results will likely have a wider impact than just on those under scrutiny and will set the immediate supervisory tone. The process and methodology will follow the same process applied in Bulgaria as part of its own route to ERM-II and Banking Union membership.

For Croatian banks, regardless of whether they have operations in the Eurozone, the immediate move to closer cooperation between the HNB and ECB in its role as the head of the Banking Union's Single Supervisory Mechanism (**SSM**) will mark a change in supervisory culture.

In a number of areas, including those outside the ECB-SSM multi-annual supervisory priorities, this will translate into a more invasive level of supervisory scrutiny including more comprehensive on-site inspections and focused thematic reviews well beyond the Comprehensive Assessment exercise that the ECB-SSM will start in respect of the Croatian banking sector.

The Comprehensive Assessment aims to ensure that all supervised firms can provide relevant information to supervisors, are fundamentally sound and have sufficient means to identify problems and implement necessary corrective actions.

One area of scrutiny that the ECB might look at from both a supervisory and central bank perspective is the business model viability in relation to exposures to the roughly 1,100 state-owned enterprises given that the ECB, on the ERM-II accession side has highlighted that these public-sector enterprises are among the most significant in emerging Europe (in terms of assets in GDP) and there are concerns on low efficiency. In addition the ECB-SSM have highlighted that they will look more closely, as they are doing across the Banking Union in general, at anti-money laundering and financial crime prevention measures.

What is the Amending Act about?

The Amending Act proposes changes to Croatia's Law on Credit Institutions i.e. the transposition of CRD IV into Croatian law, to comply with the conditions for the establishment of close cooperation between the HNB and for participation in the ECB-SSM.

The Amending Act also implements the SSM Regulation and the SSM Framework Regulation into Croatian law in order to allow the ECB to carry out its tasks concerning the prudential supervision of credit institutions established or operating in Croatia.

Under the Amending Act, once close cooperation is established, the ECB will carry out prudential supervision of credit institutions established in Croatia. The ECB will exercise the supervisory tasks defined in Article 4 of the SSM Regulation and the macroprudential tasks under Article 5 of the SSM Regulation.

The HNB will be subject to any legal acts, guidelines or requests of the ECB, and will adopt decisions in accordance with the instructions, requests or guidelines issued by the ECB or any measure proposed by the ECB in relation to credit institutions.

The HNB will, upon close cooperation being established, be elevated to a position comparable to all other Banking Union NCAs. Relevant ECB Joint Supervisory Teams will have to be established or amended to account for the coverage of Croatian firms, in particular as the ECB's supervisory teams are supposed to operate in such a way that the nationalities of the supervisors are different to the domicile of the Banking Union Supervised Institution (**BUSI**).

For the purposes of the Comprehensive Assessment, the ECB or any person empowered by the ECB may:

- request credit institutions to submit documentation;
- carry out a review of books and documentation of credit institutions, including obtaining copies of such documentation;
- request written and oral explanations from credit institutions and from their employees; and
- for the purpose of collecting information, interview any person it considers as having relevant information, provided such person provides their explicit consent.

Obligations for the HNB as well as termination procedure

The Amending Act further specifies a termination procedure in the event that termination is initiated under Article 7(8) of the SSM Regulation, whereby a Member State whose currency is not the euro disagrees with a decision of the ECB and may request the ECB to terminate the close cooperation with immediate effect.

The Amending Act provides that in the event of termination of close cooperation, the legal acts of the ECB adopted pursuant to the SSM Regulation shall cease to be applicable in the Republic of Croatia.

Becoming a full Banking Union jurisdiction

Once Croatia becomes a full member of the Banking Union, the HNB will become a full participant in the SSM and have a seat in the ECB Governing Council. Under close cooperation the HNB may only express disagreement with ECB Decisions issued by the Supervisory Board.

Additionally, as a part of the Banking Union, Croatia will have the second pillar of the Banking Union, the SRM, at its disposal. The SRM is a central institution for bank resolution, ensuring orderly restructuring of a bank by a resolution authority when the bank is failing or likely to fail. The SRM includes the Single Resolution Board (SRB) and Single Resolution Fund (SRF) financed by the banking sector. Both the SRB and the SRF strive to ensure an orderly resolution of failing banks with a minimal burden for taxpayers and the real economy.



The European Banking Union – an institutional overview

The Single Supervisory Mechanism (SSM)

The SSM refers to the system of banking supervision in Europe. It comprises the ECB and the national competent authorities (NCA) of the participating countries.

The Single Resolution Mechanism (SRM)

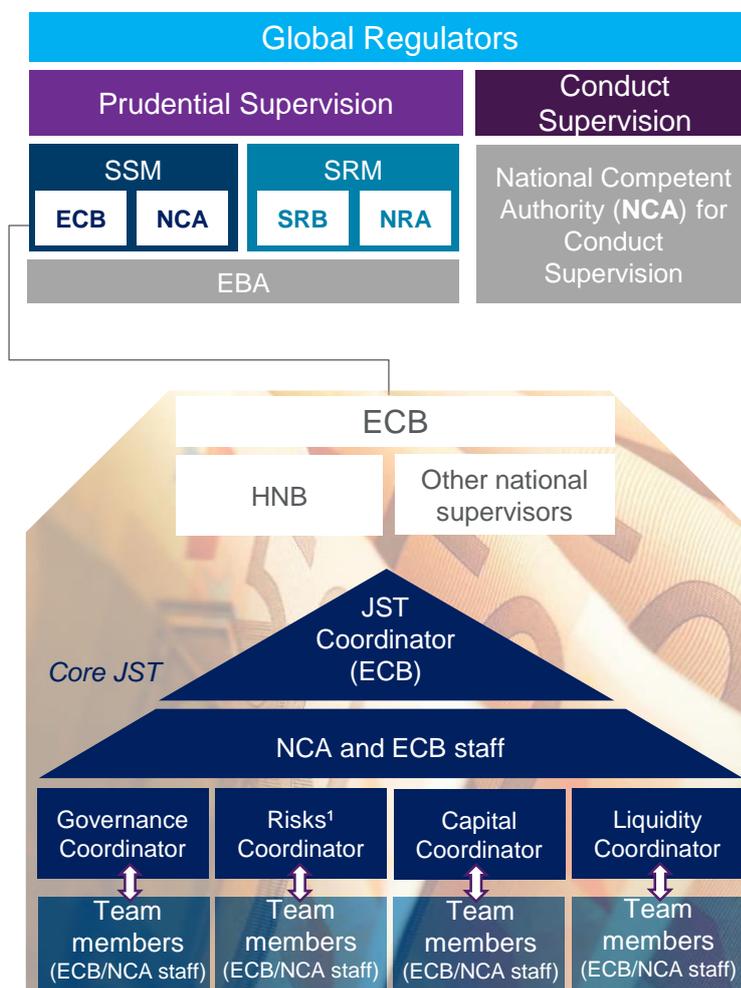
The SRM is a mechanism that established uniform rules and a uniform procedure for the resolution of credit institutions by a resolution authority. The single resolution board (SRB) together with the national resolution authorities (NRAs) are the resolution authorities for significant banks.

The European Banking Authority (EBA)

The main task of the EBA is to contribute to the creation of the Single Rulebook (by issuing a wide range of Technical Standards, Guidelines and Reports), with the objective to provide a single set of harmonized prudential as well as conduct rules for financial institutions throughout the EU.

National Competent Authority for Conduct Supervision (NCA)

The NCAs are mandated to oversee that financial institutions carry out (conduct) their business in an orderly manner (e.g. ensuring investors protection).



**A graphical representation of how the SSM "hub and spoke" model would be applied to Croatia*

Key ECB-SSM Supervisory Priorities besides making the Single Rulebook more single

- Strategic steering, compliance and governance culture and justifications for decisions;
- Reducing non-performing loans and exposures (**NPLs**) and mitigating developments in real estate markets;
- Preparing for IBOR transition and meeting Benchmark Regulation compliance;
- Repricing of risk in financial markets (ICAAP/ILAAP Readiness + TRIM) as well as Liquidity Stress Tests (LIST 2019);
- Misconduct at Banking Union Supervised Institutions (**BUSI**); and
- Cybercrime, IT disruptions and FinTech disruptors.

Key measures Croatian firms can take to prepare

- Perform a gap analysis on “strategic steering” in local operating/business units versus how to move to “Banking Union ready” Target Operating Model (**TOM**) as well as legacy and new transactions (ECB supervisory expectations on new product/transaction approval processes). For those BUSIs who are active in Croatia but headquartered in the Banking Union the process of simply rolling out a Banking Union TOM to Croatia will unlikely work nor be accepted by ECB-SSM let alone the Single Resolution Board as part of recovery and resolution processes;
- Review the level of NPLs and begin to shadow EU and ECB NPL rules both on a portfolio basis as well as work out units earmarking NPLs to priority buckets while embedding ECB-SSM and EU NPL supervisory expectations on policies and procedures;

- Review following key areas and justifications for decisions as to how it fits in with Risk Appetite, Risk and Control Framework:

- lending standards (internal policies and procedures as well as client-facing agreements – lending and security) at origination and through lifetime;
- quality control of Risk Appetite Framework and Risk Appetite Statements, Internal Capital Adequacy Assessment Process (**ICAAP**) and Internal Liquidity Adequacy Assessment Process (**ILAAP**);
- overall culture and business model sustainability including strength and resilience of control functions (governance, legal, risk and compliance teams etc.) and relevant mitigants in the form of document-driven (policies, procedures and key operating principles) as well as non-document-driven measures such as automated monitoring and reporting;

- Conduct periodic implementation testing and covert dry-runs of credit models, rules and origination process to ensure they are fit for purpose including in light of the bank’s business model, size, complexity, risk exposure and market expectations; and
- Assess 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.

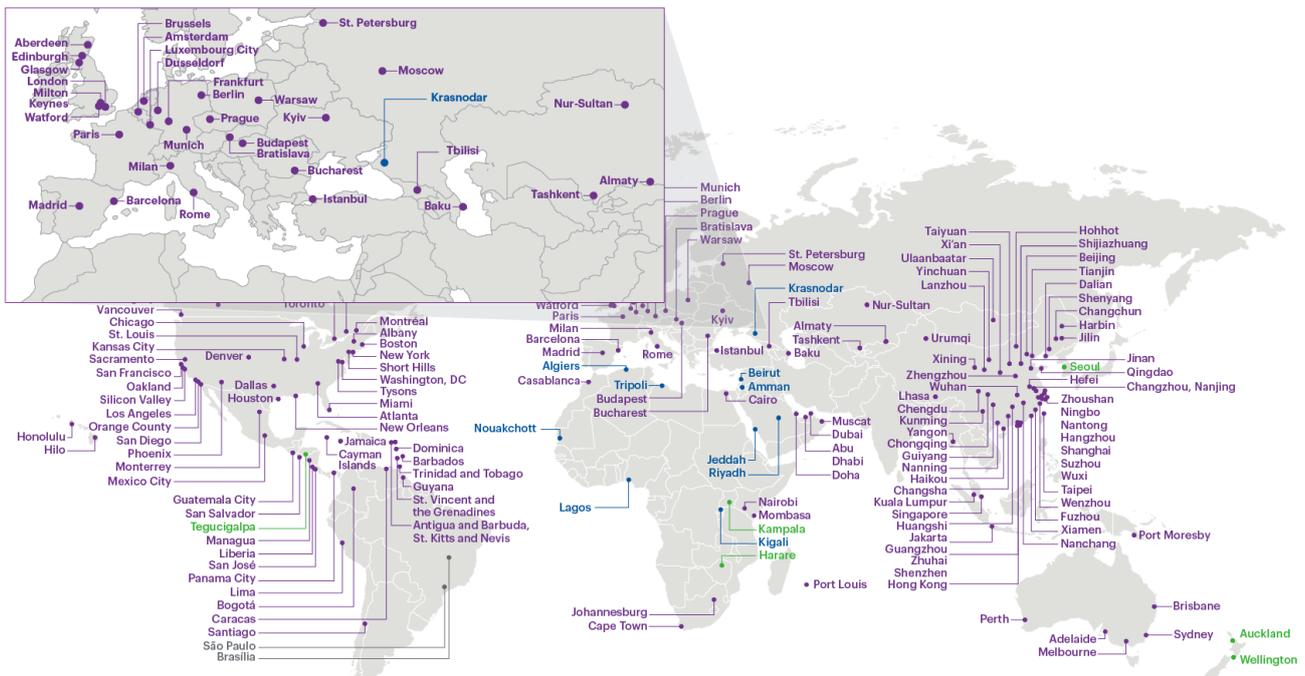
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Your Key Contacts in our Frankfurt-based Eurozone Hub



Michael Huertas, LL.M., MBA

Partner
Co-Head Financial Institutions
Regulatory Europe

D +49 69 45 00 12 330

M +49 162 2997 674

E michael.huertas@dentons.com

Michael Huertas is a partner in our Frankfurt office, a member of our Banking & Finance Practice and Co-Head of the Financial Institutions Regulatory Sector Group in Europe. Michael leads our Frankfurt-based Eurozone Hub and the wider Eurozone Group. His structured finance practice focuses on derivatives, securities financing transactions and securitizations. Michael also has experience advising on conduct of business and governance arrangements (in particular, the managing of non-performing assets) and financial market infrastructure, collateral and custody arrangements.



Dr. Holger Schelling

Partner

D +49 69 45 00 12 295

M +49 162 1041 413

E holger.schelling@dentons.com

Dr. Holger Schelling is a partner in Dentons' Frankfurt office and a member of the Banking & Finance practice. He advises banks, investment firms, fintechs and other financial institutions on financial regulation, including banking regulation, securities regulation and payment services regulation. He has successfully advised domestic and international clients on the implementation of regulatory changes, such as MiFID II, BMR and the reform of EURIBOR and LIBOR, PSD2 and EMIR. He provides commercially minded advice on innovative technology such as online payment services, robo advice and blockchain technology.



Dr. Kai Goretzky

Counsel

D +49 69 45 00 12 340

M +49 162 2038 011

E kai.goretzky@dentons.com

Dr. Kai Goretzky is a counsel in Dentons' Frankfurt office and part of the insurance team. He has focused on insurance contract law, intermediary law and supervisory law, as well as the specific compliance issues of the insurance industry. He advises international clients on setting up and conducting business in the European insurance market as well as small and medium-sized insurers under Solvency II. Another focus of his practice is the digitization of the insurance industry. In addition, he advises banks and funds on specific insurance topics and has experience in insurance-related M&A transactions.