Executive summary

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of a number of euro-area banking groups in central and south-eastern Europe has bene tted the host countries and has strengthened the resilience of those banking groups. But this integration has become less close because of post- nancial crisis national rules that require banks to hold more capital at home, or other ring-fencing measures. ere is a risk integration might be undermined further by bank resolution planning, which is now gathering pace.

will need to decide between two distinct models for crisis resolution, and this choice will rede

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1 Introduction

The adoption of a bank-resolution regime has been a key step in the European Union's quest to end taxpayer-funded bail outs and to quash the presumption that some financial institutions are too big to fail. Since 2015, the Single Resolution Board (SRB) has quickly established itself as the banking union's central resolution authority and has set per-bank targets for additional funding that could be subject to bail-in.

Under the 2019 revision to the EU Bank Resolution and Recovery Directive (BRRD), and the regulation governing the SRB, these targets for bail-in capital have been more accurately calibrated[1]. Requirements for the largest euro-area banking groups now closely resemble those for global systemically important banks (G-SIBs), which began resolution planning already in 2014 under the guidance of the Financial Stability Board (Bolton and Oehmke, 2018)[2]. Crucially, the new EU requirements for bail-in capital now also apply to the subsidiaries of cross-border banking groups. Since late 2019, the SRB has also begun to clarify which operational and legal obstacles to a possible resolution will need to be addressed by banks (SRB, 2019). This could usher in a major transformation for banking groups that have so far run integrated cross-border operations.

However, the bank-led plans for recovery from a crisis and the SRB's plans for resolution of institutions that have failed, re-open questions of how the international subsidiaries of euro-area banking groups would fare in a banking crisis in either the parent's home or a host country.

Nowhere is cross-border resolution planning more important than in central and south-eastern Europe[3]. The subsidiaries of euro-area banks in this region are typically systemically important within their respective host countries, though supervision and crisis planning will depend on close cooperation with the authorities in the parents' home jurisdiction. Many vestiges of post-crisis ring-fencing persist in banking markets of both home and host countries, and continue to undermine this cooperation.

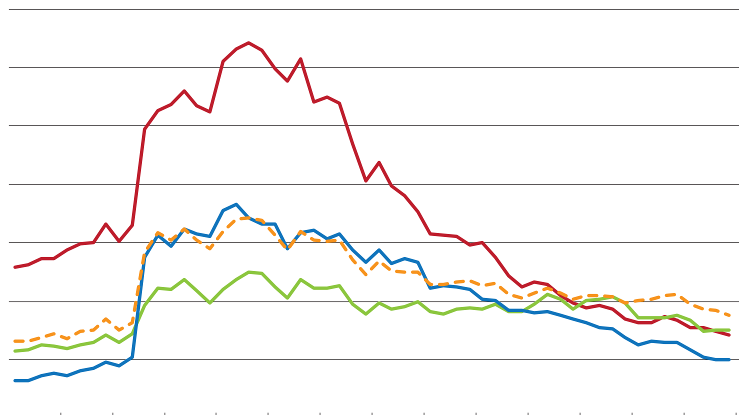
Planning for the resolution of a large euro-area cross-border banking group involves preparing for a worst-case scenario that might never come to pass, but must nevertheless be realistic. This Policy Contribution reviews the current state of financial engagement by

2 Euro-area banking groups in central and south-eastern Europe

Up until the crisis of 2008-09, the deep nancial integration fostered by the subsidiary networks of European cross-border banks in the central and south-east Europe region served the rst phase of economic transition well. e presence of foreign-owned banks in the region's banking markets is more marked than in any other emerging-market region. Empirical evidence overwhelmingly points to bene ts in terms of nancial stability and overall growth[4]. However, such integration has also led to a number of vulnerabilities, for instance in the form of excessive lending in foreign currencies or to property sectors.

In the aftermath of the crisis, a sharp and protracted deleveraging of bank exposures set in between 2008 and 2016 (Figure 1). e reduction in cross-border bank funding in central and south-eastern European countries was particularly sharp compared to other emerging markets, though their nancial systems were quickly stabilised by a number of International Monetary Fund programmes, such as in Latvia and Hungary. e Vienna Initiative, an essentially *ad-hoc* public-private forum, provided coordination between network banks, international institutions and home and host authorities. is e ort succeeded in limiting liquidity out ows, which stabilised by about 2015, and limited imposition of ring-fencing strategies by host countries.

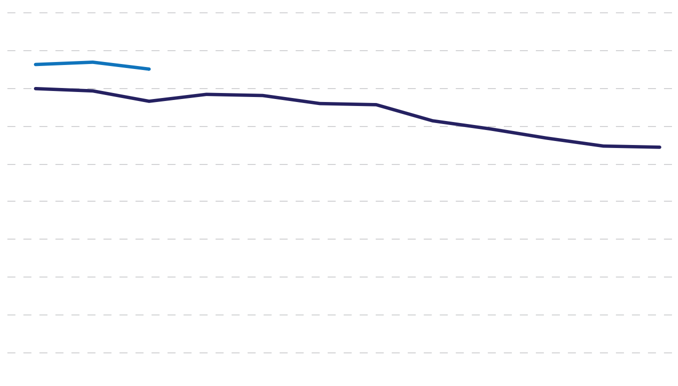
Figure 1: External positions of foreign banks towards EU countries in central and eastern Europe, % of GDP



Since the nancial crisis, a number of euro-area banking groups have withdrawn from the central and south-east Europe region, re ecting consolidation in their home markets. Foreign acquisitions of banks in the region have become rare. On the contrary, banking networks originating within the region have grown, most notably the Hungarian bank OTP. Nevertheless, the market shares of foreign-owned banks remain near their peak in south-eastern Europe (at 78 percent), though they have fallen by about 15 percentage points over the past ten years in the Czech Republic, Hungary, Poland and Slovakia (Figure 2). Overall, foreign ownership stakes have narrowed (and those of local state-owned banks expanded), though foreign networks remain largely intact.

4 See for instance EBRD (2009), which documented the growth e ects of capital in ows.

Figure 2: Market shares of foreign- and state-owned banks in central and south-eastern European countries (% of total assets)



A signi cant number of banking groups based in the euro area, under ultimate European Central Bank supervision, continue to operate extensive subsidiary networks in central and south-east Europe. Banking groups from Austria, Italy and France are deeply engaged in markets that have turned out to be consistently pro table and which, since the nancial crisis, have generated steady asset growth in excess of their euro-area home markets. Subsidiaries are typically signi cant within host markets, and are often also signi cant individually within the respective banking groups (Table 1 lists the largest groups with their respective host country market shares and the signi cance of individual subsidiaries in total group assets)[5].

Home-host cooperation in supervision and resolution planning will remain particularly complex outside the banking union, given two broad trends over recent years:

- First, funding models that previously relied on wholesale markets and parent-bank liquidity lines have become less risky because of a much greater reliance on local deposits, and in some countries on local debt markets (Figure 3 documents this increase in deposit-to-loan ratios). By funding themselves largely through local deposits, subsidiaries have become more decentralised and potentially amenable to local resolution schemes. Separation from the parent can now be foreseen, at least in nancial terms.
- Second, euro-area authorities must confront a much greater scepticism on the part of local regulators about the nancial-stability implications of foreign-bank presence. is has been evident in preferential treatment for local banking champions, and in some instances through explicit goals of increasing domestic ownership in the sector.

EU banks' withdrawal from international exposures following the nancial crisis appears to have been much sharper than that of cross-border banks from other regions, such as Japan or the United States (McCauley *e al*, 2017).

Despite the strengthening of bank balance sheets, nancial integration in the EU has not markedly recovered since the crisis. ECB assessments show that a composite indicator of nancial integration within the euro area based on price measures has recovered, though it remains below pre-crisis levels. An indicator based on the extent of cross-border exposures has continued to decline (European Commission, 2019). Figure 4 shows the external claims of euro-area banks on six central European countries and on other countries in the currency area, and shows that these have been closely aligned.

5 Based on RBI (2019), the dominant banking groups in central Europe are Erste Bank of Austria, KBC, Santander, Unicredit, SocGen, RBI, Commerzbank, ING, BNP, Intesa and Millennium Bank. In addition, Slovenian bank NLB and Greece's Eurobank operate in the south-east Europe region.

Table 1a: Share of euro-area banks• subsidiaries in host country total banking assets (%), 2017

		Erste	Intesa	KBC	Nordea	Rai eisen	Société Générale	UniCredit	Euro-area banks*
Non-euro area EU	Bulgaria			8.2%		8.1%	7.8%		62.9%
	Croatia					7.8%			75.8%
	Czech Rep.					5.4%	8.6%	8.6%	85.8%
	Hungary	2.4%	5.1%	9.1%		6.6%		8.3%	38.5%
	Poland					3.3%	0.9%		52.7%
	Romania	9.5%	1.1%			9.4%			65.0%
Euro-area	Estonia								14.2%
	Latvia								18.1%
	Lithuania								27.1%
	Slovakia							7.3%	89.3%
	Slovenia		6.8%				9.0%	7.8%	37.5%
Non-EU	Albania						5.5%		43.8%
	N. Macedonia						8.3%		52.5%
	Montenegro								41.3%
	Serbia	4.6%				7.3%	8.0%		61.0%

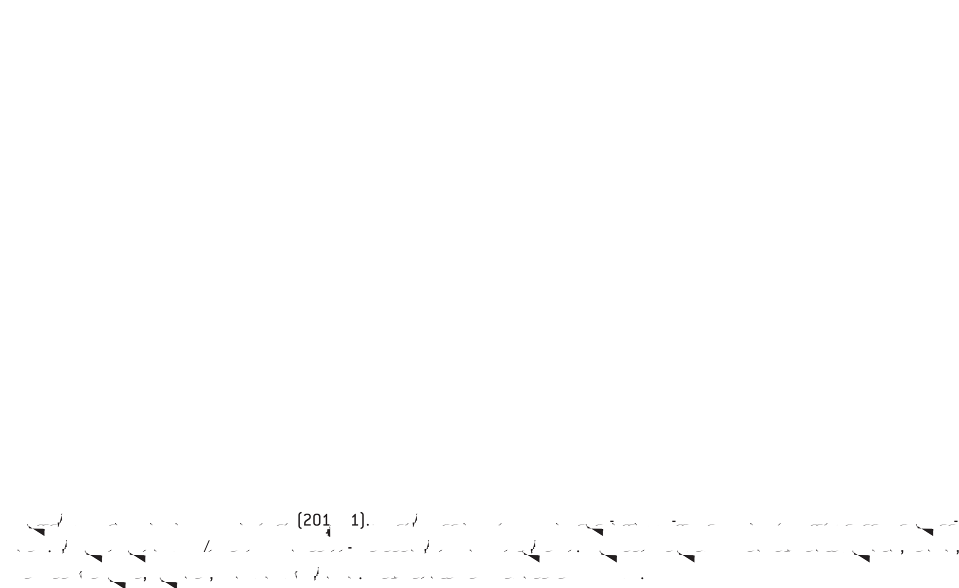
Notes: Table shows all euro-area banks present in at least three central and south-eastern European countries. Green cells = <5%. Yellow cells = 5-10%. Pink cells = >10%. Data is missing for Erste North Macedonia and Intesa Czech Republic; market share in these countries might be underestimated. Slovakia “gures Unicredit captured under the Czech Republic and decoupled based on World Bank “gures. * Corresponds to the combined market share of euro-area banks in each of the host countries, based on geographical location of the ultimate parent bank (as de“ned by the SNL Financial database).

Table 1b : Share of euro-area banks• subsidiaries in group assets (%), 2017

Bank	Home country	Resolution strategy	BG	HR	CZ	HU	PO	RO	EE	LV	LT	SK	SI	
Banco Santander	ES	MPE	-	-	-	-	2.5	-	-	-	-	-	-	2.5
BNP Paribas	FR	unclear	-	-	-	-	1.5	-	-	-	-	-	-	1.5
Crédit Agricole	FR	SPE	-	-	-	-	0.3	0.0	-	-	-	-	-	0.3
Deutsche Bank	DE	SPE	-	-	-	-	0.6	-	-	-	-	-	-	0.6
ING	NL	SPE	-	-	1.0	-	3.6	-	-	-	-	-	-	4.6
Société Générale	FR	SPE	0.3	-	3.3	-	0.3	0.9	-	-	-	-	0.2	5.0
UniCredit	IT	SPE	1.2	2.0	2.5	1.1	-	1.1	-	-	-	0.6	0.3	8.9

Figure 3: Deposit-to-loan ratios in central and south-eastern EU countries

Figure 4: Loans by euro-area banks by residence of the counter-party (% of GDP)



An assessment of whether central and south-eastern European financial markets have become more or less integrated with the rest of the euro area would yield different answers depending on which of the three common empirical measures is used:

2018). e ECB has argued for some time that the common prudential standards within the

direction of the home-country authority[6]. Subsidiaries in host countries issue bail-in capital (equity and sub-ordinated bonds) to a parent or holding company. This is loss-absorbing capital (in EU terminology, the minimum requirement for own funds and eligible liabilities or MREL) that is internal to the group and no other investors hold these liabilities[7]. Only the holding company would issue MREL-type sub-ordinated bonds into the market under home-country law, and holding-company MREL is at least as large as the sum of all internal MREL issued to it by all subsidiaries.

Once losses occur within any subsidiary, the parent will need to inject capital to meet host-country regulation for capital coverage, or if necessary, convert internal MREL into equity. Losses are passed up and capital is passed down.

However, if the subsidiary is large enough, its losses might put at risk the entire holding company (in EU terms, render it failing or likely to fail). As the holding company enters resolution, the home authority implements its global resolution plan, and there is no need for different national insolvency proceedings. All assets are valued but resolution tools are implemented at the holding-company level only (the resolution entity). Its equity is written off, subordinated debt issued by the holding company may be converted into equity, and other senior bonds might suffer the same fate. This allows the recapitalisation of the subsidiaries.

A key feature of this model is that, at least initially, the ownership structure of the group remains intact. Underlying profitability problems, including in the host countries, can be dealt with based on a group restructuring plan. As subsidiaries issued subordinated debt only to the holding company, only its investors are subject to a bail-in within the resolution scheme. Other host-country liabilities of the subsidiary will remain senior to those of the holding company. A key benefit of SPE is that only one agency – in Europe, most likely the SRB – will be in charge. The solution is also efficient in preserving equity, which can be allocated wherever needed within the group.

However, it is essential that all home and host-country authorities cooperate in this solution. For example, should a loss occur in a single subsidiary and deplete the capital at hold-

resolution schemes might well be inferior to both of the stylised regimes set out here. Of three competing objectives – nancial stability, cross-border banking and national crisis-resolution policies – only two can be attained simultaneously (Schoenmaker, 2017).

4 Priorities for three groups of countries

Whether a bank opts for a single resolution scheme or one administered in multiple jurisdictions depends on its business model and to what extent individual units would be separable in a resolution (and this initial choice would then need to be approved by the resolution college). SPE has been the preferred model for groups where wholesale banking dominates and where there are substantial exposures between di erent parts of group, such as in investment banking. Conversely, the MPE model appeals in particular to retail banks with local deposit funding, which operate as separate businesses, albeit with shared central services and common risk-management standards.

At the time of writing, resolution colleges have not nalised these decisions, which would in any case be revisited regularly (Table 1b lists the banks' early choices as disclosed in investor disclosures). e two leading Spanish banking groups, BBVA and Santander, have opted for MPE, based on the long-standing decentralisation of their Latin American subsidiaries (BBVA, 2014). Austrian groups Erste and Rai eisen International, each with extensive subsidiary networks in central Europe, similarly opted for this model. However, UniCredit Group, present in nine countries in central and south-east Europe, structures itself around a single point of entry.

Banking groups now need to become 'resolvable' in line with their chosen models. e need to choose between the two models has already resulted in wide-ranging changes to the legal, organisational and nancial structures of European banking groups. SPE banking groups have established holding companies that now issue subordinated bonds for the entire group. For groups under an MPE scheme, operational resolvability is clearly a key challenge. Groups have reorganised into regional and functional sub-groups, often with associated holding companies subject to individual SPE resolution schemes. Common services such as IT, treasury or marketing have been separated into entities that would not be a ected by a resolution of the group.

In practice, the choice between the two models may not be clear-cut and various hybrid solutions have been designed, for instance through regional holdings, or where a subsidiary in one host country manages bank branches in another.

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4.2 EU countries outside the banking union

ree key host countries with a signi

scheme, some subsidiaries are owned to a signi cant degree by local investors. Poland, for instance, has had a long-standing policy of fostering equity issuance of foreign-bank subsidiaries on the local market.

Host countries will be especially keen to ensure that the losses and recapitalisation needs of local subsidiaries in a single-point-of-entry scheme can be passed with legal certainty to the resolution entity in the euro area. e Financial Stability Board guidance (FSB, 2017) that covers the design of internal bail-in funds of G-SIBs is instructive in this regard:

- Issuance should ideally be direct from the subsidiary to the parent;
- Internal MREL should be governed by host-country law, as this gives the host resolution authority the option to apply its own powers if the home authority (SRB) does not trigger conversion of MREL;
- Home authorities should not subject internal MREL to large exposure limits;
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tagion, which the home country has only limited powers to contain. is overlooks the fact that a host-country supervisor outside the euro area always has the ultimate power to declare a subsidiary as failing, and in doing so would trigger conversion of bail-in funds (whether or not these are internal).

Table 3: Local bond market capitalisation (% of GDP) by sector of the issuer

	Euro area	Bulgaria	Croatia	Czech Rep.	Hungary	Poland	Romania
Total outstanding stock	105.5	4.2	19.3	75.3	55.7	40.7	16.1
thereof							
Govt. bonds	68.8	3.9	18.3	26.1	51.6	31.7	16
Corporate bonds	9.6	0.3	0.9	2.3	0.5	3.9	0
Bank bonds	27.1	0	0.1	46.9	3.6	5.1	0.2

e second concern about MPE resolution plans is that the integrated structure of banking groups in the region might not be amenable to local resolution schemes. Unlike the group-wide resolution plan in the SPE model, the resolution plan conceived by the host country in the MPE scheme in principle requires the operational and nancial separation of two or more resolution entities (eg made up of a subsidiary and the entities under it) within the overall banking group. Under the BRRD, it is within the host country's powers to direct the resolution e

so that host countries have allowed the SRB take a lead in designing group-wide resolution schemes[12]. All countries have secured a determination from the European Commission that their con dentiality standards are equivalent to those in the EU and the SRB has signed cooperation agreements with its counterparts in Serbia and Albania. Nevertheless, much could be done to improve cooperation, in particular by involving host authorities in a wider range of supervisory processes, in particular in resolution colleges. tru-eas7(tnhe E)10.9(u)-.1(r)14.9(o)-.1(peaEUf)]T

banking union will implement independent resolution planning.

- € Local resolution plans in large host countries will need to be reconciled with the SRB-led schemes which might only cover part of a