A.1 Introduction

The provision of cross-border banking services via branches is an important and dynamic part of the financial system in a number of Member States. In several countries, there has been an observed decline in the number and share of subsidiaries since the financial crisis which has been accompanied by an increased role for branches (see Figure A.1). In many cases, significant increases in the share of branches have been directly linked to the transformation of subsidiaries into branches (so-called branchification) rather than to the organic growth of branches. One notable example of such transformation is the recent decision by Nordea to convert its Finnish, Danish and Norwegian subsidiaries, which were identified as other systemically important institutions (O-SIs) in their host countries, into branches in early 2017.79,80

The evolving position of branches could have important implications for macroprudential policy. Branches are not legal entities in their own right and are, from a legal point of view, part of the parent undertaking. As such, they are supervised by the competent authority of the home Member State and their regulatory treatment may differ from that of subsidiaries. The prudential supervision of subsidiaries, on the other hand, is the responsibility of the competent authority of the host Member State. This sharing of responsibilities in prudential supervision of cross-border entities applies in part also to macroprudential policymaking. In particular, some macroprudential measures adopted by authorities of the host Member State may be directly applicable only to financial institutions authorised in that Member State. In order to be fully effective, however, macroprudential policy needs to apply to all relevant institutions (directly or via reciprocity measures) so that the risk of regulatory arbitrage and leakages is reduced.

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78 Prepared by Tomáš Konečný and Ľuboš Šesták with research assistance from Pedram Moezzi (all ESRB Secretariat).


80 Only a few countries experienced a rise in the number (Austria, Estonia, Finland, Italy) or share (Belgium, Slovenia, Portugal, France) of subsidiaries. A significant increase in the share of subsidiaries can be linked to cross-border mergers and acquisitions.
A.2 Cross-border penetration and branches across the EU

The degree of cross-border financial penetration varies significantly across Member States. Foreign institutions\(^81\) have a majority of banking assets in 16 Member States and the share of

\(^{81}\) The term “foreign institutions” refers to subsidiaries or branches with the full or majority ownership/control by a financial institution headquartered outside the country where the subsidiary/branch is located.
branches has been rather limited so far (see Figure A.2). The share of foreign subsidiaries is nonetheless quite significant in particular in central and eastern European (CEE) countries, Baltic countries and smaller economies. The market share of foreign affiliates (i.e. branches and subsidiaries combined) exceeds 75% in seven CEE countries and Luxembourg. The market share of branches in these countries is between 0% and 25%. The share of foreign affiliates is also substantial in another eight countries, ranging between 40% and 60%, where in Finland and Malta the share of branches exceeds 40% of total banking assets. On the other side of the spectrum, there are seven countries where financial penetration is currently low and the share of foreign affiliates is below 10%. The share of non-EU branches and subsidiaries is generally significantly lower than the shares of EU branches and subsidiaries, with the exception of Malta, Ireland and the United Kingdom.

**Member States with highly overbanked markets** generally have a low degree of cross-border penetration. Overbanking combined with a very low degree of cross-border financial penetration in large EU economies points to persisting market fragmentation and obstacles to banking sector consolidation at the EU level. At the same time, despite the already high foreign presence in a number of countries in the CEE and Baltic region, markets in these economies are still relatively less developed compared to their EU peers. Going forward, economic growth and progress in the integration of the European market in banking services might contribute to a more balanced picture of the European banking sector.

A low degree of cross-border penetration across a number of large EU economies may weaken their ability to appropriately address asymmetric macroeconomic shocks. Macroeconomic shocks may propagate in the single market (and even more so in a monetary union) and spread across borders without national authorities being able to address them in an adequate manner. The use of the exchange rate in addressing such shocks may be possible, even outside the euro area. Furthermore, the usual redistributive (fiscal) policy tools may not be available to a sufficient extent to be really effective. To counteract such episodes of shocks, national adjustment can be facilitated if the banking sector can benefit from funding, lending and investment across the single market. The lack of a sufficient number of large EU-wide players is likely to have contributed to the severity of the recent euro crisis as asymmetric shocks simultaneously affected the same national sovereigns, economies and banks.

The heterogeneity in the number and total assets of foreign branches across the EU host countries is substantial. In particular the Nordic and Baltic countries can be regarded as a “laboratory” for large branches. First, in a number of these countries some branches are major, if not dominant, players in the retail market (e.g. the Nordea branches in the Nordic and Baltic countries before the creation of the Luminor bank in October 2017). Second, the relatively large size of the banking sector in the region serviced by branches is further highlighted by the high number of branches with market shares in top quintiles of EU figures. There are similar cases in the rest of the EU both in terms of the overall market share and its composition, although with some important differences. Some other countries have a large overall share of branches in their banking sectors (e.g. Belgium, Slovakia and Romania, all exceeding 10%). Ireland and Luxembourg are

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82 After the planned move of Nordea’s headquarters from Sweden to Finland, the situation in Sweden and Finland will change.
83 ESRB (2014), “Is Europe overbanked?” Reports of the Advisory Scientific Committee, No 4, June. The assessment of overbanking includes the size, recent growth, concentration and leverage of the European banking system in comparison to other banking systems.
84 According to an ESRB survey, 8 out of 12 branches with a market share of more than 5% in the local market were located in the Nordic / the Baltic countries.
similar to the northern European region in terms of a relatively skewed distribution of market shares of individual branches. Nonetheless, branches in these two latter countries have a rather specific profile, the key distinction being that the primary focus of most branches is on investment banking-type activities as opposed to retail banking activities.

**Designated O-SII subsidiaries of foreign parent institutions play a significant role in the banking sectors of a number of host countries.** O-SIIs are institutions that can pose risks to financial stability and contribute to market distortions due to their size, complexity or provision of critical services. In eight Member States, foreign institutions designated as O-SIIs hold more than 50% of total banking sector assets. In Croatia, the share reaches almost 90%. All foreign O-SIIs are subsidiaries of EU-based institutions. The designated O-SII subsidiaries of foreign parent institutions are natural candidates for possible cases of branchification relevant from a financial stability perspective.

**Figure A.2**

**Heterogeneity across the EU – share of foreign affiliates in total banking sector assets and banking assets relative to GDP across the EU in 2017**

According to a survey conducted by the ESRB’s Instruments Working Group in mid-2017, the majority of conversions of subsidiaries into branches related to instances of a relatively minor importance to the banking system of the host countries. At the time of the survey, there were 13 EU branches and 3 non-EU branches with an asset market share greater than 5% in the local market and a further 44 EU-branches and 9 non-EU branches with a market share above 1%. Members also reported 43 cases of branchification between 2005 and 2017, of which 37 were after 2010.

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85 The calculations used consolidated data for all foreign subsidiaries designated as an O-SII obtained from the SNL database and sums of consolidated banking assets for each EU country and Norway regardless of the origin of the parent company.

86 The survey focused on the conversion of subsidiaries into branches. However, it also aimed to map the distribution of major branches across the EU and to identify potential financial stability implications.
the financial crisis. According to the survey, business optimisation has been the main driver for branchification; cost savings, a more efficient structure, regulatory burden, prudential requirements, market exit strategy and regulatory arbitrage were in some cases mentioned as additional reasons.

**Some conversions, however, raised questions about their potential impact on financial stability.** These include Nordea’s conversion of its three Finnish, Danish and Norwegian O-SII subsidiaries into branches in early 2017. A unique feature of the Nordea example is the size of the subsidiaries being converted into branches. At the time of conversion, the subsidiaries in Finland, Denmark and Norway represented about 40%, 10% and 9% of total banking sector assets in the three countries, respectively. The transformation of the Finnish subsidiary furthermore involved the creation of a new subsidiary called Nordea Mortgage Bank which retained the mortgage lending part of former Nordea Bank Finland. Nordea’s Board of Directors decided on 6 September 2017 to initiate the relocation process of the bank’s headquarters to Finland.

The survey listed another case where an identified O-SII subsidiary was converted into a branch; however another three significant branches were converted before the introduction of the O-SII framework. The case of the identified O-SII was the conversion by the French bank CASCEIS of its Luxembourg subsidiary as of end 2016. The other cases include Lithuanian AB SAMPO bank converted into the Danske Bank A/S Lithuania branch in mid-2008, an Estonian branch of Danske bank and Slovak Unicredit bank in 2013. In other cases, branchifications were of minor importance for the banking sectors of the Member States concerned.

**The forthcoming cases of major branchifications are likewise concentrated in the Nordic/Baltic countries.** Following a pattern similar to Nordea in Finland, Danske Bank merged its Finnish banking activities into Danske Bank A/S, Helsinki branch in December 2017. Danske Bank Finland plc (DBK) transformed into a branch and a separate covered bond bank was established as required by Finnish law to issue covered bonds. Mortgage loans that are used as collateral were carved out from the balance sheet of DBK and transferred to the balance sheet of the new Finnish subsidiary. Furthermore, a new stand-alone bank (Luminor) with a share of 23% of the Baltic lending market was created in October 2017 following the merger of the operations of the Nordea branch and the DNB subsidiaries in the Baltic countries. While the bank has initially retained its independent governance and has an arm’s length relationship with its two parent banks, Nordea and DNB, branchification of the newly created joint entity is planned to commence in 2019-20 with the home authority of the Luminor bank being based in Estonia. Although these cases are concentrated in the Nordic/Baltic countries, the completion of the banking union could foster further financial integration within the euro area, thus leading to an increased trend of branchification.

### A.3 Prudential treatment of branches in the EU

#### a) Microprudential perspective

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88 In another three cases (Estonia, Greece, Slovakia), branchification with a likely O-SII dimension occurred before the O-SII framework was introduced.


Credit institutions can in principle conduct foreign operations through three main channels: (i) by establishing a subsidiary; (ii) by establishing a branch; and (iii) by providing direct cross-border services. A subsidiary, as a stand-alone credit institution (i.e. a separate legal entity) established in a foreign market, is subject to solo prudential regulation requirements in the foreign market. A foreign branch is not a separate legal entity; it generally requires a licence from the foreign authorities and is subject to at least some prudential regulation in the foreign market. Finally, the possibility to provide direct services across borders without establishing any formal presence in the foreign market is subject to different international or bilateral agreements.

The EU regulatory framework for banks (CRD IV and CRR)91 provides a simple and unified set of prudential rules for conducting cross-border activities in the EU (principles of the single market and the single rulebook). The level of integration deriving from the Treaty’s freedom of establishment and free flow of services is enhanced by the harmonised prudential framework that introduces the single EU passport. Under this regime, home country licensing decisions are mutually recognised by all other host supervisors in the EU/EEA. As a result, any bank with an EU/EEA banking licence is allowed to provide cross-border financial services across the EU (subject to notification of the home authority), either by establishing a branch in a host jurisdiction or by directly providing cross-border services without establishing a formal presence.

The supervision of the branch is carried out by the competent authority of the parent institution (home authority).92 Nonetheless, under special circumstances host authorities might take precautionary measures in order to safeguard financial stability of the host Member State. The supervision of cross-border operations of banks is, however, facilitated by the establishment of close collaboration and exchange of information with host supervisors, which also contributes to protecting financial stability in the host jurisdictions. Contrary to the supervision of subsidiaries, the host authority does not have access to regular supervisory reporting which is collected by the home authority. In this respect, a functional exchange of information becomes critical for the effective supervision in the host Member State.

For branches with a significant role93 within the financial system of the host country, the single rulebook introduces enhanced provisions for host authorities. These provisions primarily concern easier access to information on the branch and the group from the home authority and the right of the host country’s competent authority to participate in the college of supervisors that is a platform for the coordination of supervisory activities. Host authorities are also consulted on the recovery and resolution plans of the group with a significant branch in their jurisdiction; home resolution authorities should give due consideration to the interests of each Member State where

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91 Directive 2013/36/EU of the European Parliament and of the Council on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (CRD IV) and Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms (CRR).

92 Under special circumstances host authorities might take precautionary measures in order to safeguard the financial stability of the host Member State. In particular, in an emergency situation and pending the home authority’s measures, the host competent authority can take proportional precautionary actions to protect against financial instability that would seriously threaten the collective interests of depositors, investors and clients in the host Member State (Article 43 of the CRD). It can also take appropriate measures to close down cross-border operations or restrict the services provided by a credit institution if they are against the interests of the general good of the host jurisdiction (Article 44 of the CRD).

93 Host competent authorities can designate branches as significant (Article 51 of the CRD) with particular regard to the following: (i) the branch’s market share in deposits exceeds 2%; (ii) the closure or suspension of the branch’s operations is likely to have an impact on systemic liquidity, payments, clearing and settlement systems; and (iii) the size and importance of the branch within the host financial system.
significant branches are located, especially regarding the financial stability of those Member States.94

The EBA Guidelines on supervision of significant branches95 provide further strengthening of a framework for the supervision of significant branches. By establishing the concept of so-called significant-plus branches, the guidelines aim to improve on the outcome of the supervision and recovery planning of the institutions concerned, without interfering with the existing legislation. For branches to be significant-plus, they should qualify as significant under Art 51 of the CRD, perform critical functions and be assessed either as important for the group or as important for the financial stability of the host Member State. The enhanced framework envisages intensified supervision, cooperation and coordination between the competent authorities. Furthermore, it is considered that significant-plus branches should be reflected in the risk assessment of the supervised institution, with an enhanced role for significant-plus branches within resolution planning. While the Guidelines operate fully within the microprudential supervisory framework, they also consider coordination of macroprudential measures relevant to the significant-plus branch.

Furthermore, the banking union provides additional harmonisation through the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM). Exclusive competencies granted to the ECB by the SSM Regulation96 include: (i) authorisation of credit institutions and withdrawal of the banking licence; (ii) tasks of the home authority with regard to establishing branches or the provision of cross-border services outside the banking union; (iii) assessing the acquisition of qualifying holdings in credit institutions; (iv) supervision of significant institutions within the SSM; (v) tasks of the host authority with regard to establishing branches or provision of cross-border services from institutions outside of the banking union; and (top-up) national macroprudential measures if deemed insufficient. The distinction between home and host authorities has diminished within the banking union and the colleges of supervisors have been replaced by Joint Supervisory Teams.97 The SRM provides for a single resolution framework within the banking union by means of the Single Resolution Board.

b) Macroprudential perspective

The macroprudential policy framework should be able to mitigate systemic risks regardless of the structure of the financial sector. The key task of macroprudential policy is to prevent and mitigate cyclical and structural systemic risks either by limiting the build-up of risks or by increasing the resilience of the financial sector. The structure of the financial sector might influence the transmission mechanisms as well as the appropriateness and efficiency of available macroprudential policy tools. A growing role of branches might thus alter the way the financial system responds to local and external shocks and provides key functions to the host economy in

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95 The Guidelines will apply from 1 January 2018.
97 ECB Regulation (EU) No 468/2014 of 16 April 2014 establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities.
times of stress and across the financial cycle. This dynamic might also call for the adjustment of the macroprudential policy mix to address the ensuing shift of systemic risks.98

However, the macroprudential policy options of the host authority might be limited as branches (unlike subsidiaries) do not need to hold own capital. Capital cannot be allocated in the host Member State, be it through an O-SII buffer or any other type of capital buffer. Macroprudential capital buffers linked to exposures of a branch may be imposed at the consolidated level. In the case of the CCyB or systemic risk buffer, the application relies on mandatory and voluntary reciprocity mechanisms following Articles 136, 137 and 134 of the CRD respectively. In the case of an O-SII buffer, however, the systemic aspect of cross-border activities in individual host countries is reflected only indirectly as a part of the overall cross-border activities of the parent undertaking.

The macroprudential policy of the host country therefore needs to rely more on reciprocity to address systemic risks. The CRR prescribes mandatory reciprocation in the application of risk weights and criteria (Article 124(5)) and the higher minimum LGD values (Article 164(7)) to exposures secured by (commercial and residential) property. Mandatory reciprocation is also applied to the CCyB up to the level of 2.5%. Furthermore, voluntary reciprocation is foreseen for the CCyB in excess of 2.5%, national macroprudential measures introduced under Article 458 of the CRR and the systemic risk buffer99.

However, for any other measures, either regulated by Union law (Pillar 2, O-SII buffers) or non-harmonised measures (such as LTV and DTI), reciprocity arrangements are either not applicable or some of the tools may not even be available in the reciprocating countries. Reciprocation of such measures is subject to the availability and willingness to use these instruments in the home country. Even if measures also apply to branches,100 the supervision of compliance is conducted by the home competent authorities or the SSM. Therefore, strong policy coordination is necessary to ensure that national macroprudential policy remains effective and does not create negative spillovers to other jurisdictions. Given its mandate, the ESRB actively assesses national macroprudential measures, analyses potential cross-border effects, and recommends reciprocity to mitigate risk of circumvention. Since its inception, the ESRB has advocated that the scope for reciprocity be enhanced and mandatory reciprocity be further developed and extended, especially regarding exposure-based measures101.

Macroprudential authorities need to have access to information which is relevant to perform their tasks. Reporting obligations of branches are lower than for subsidiaries. If a significant part of the national market is operated by branches, this could limit the ability of the macroprudential authority to identify and assess systemic risks. For significant branches, additional data could be collected through supervisory cooperation. However, the data should not be shared only with the

98 Branchification might also raise potential financial stability risks associated with the shift in responsibilities in the coverage by deposit guarantee schemes (DGS). The fact that deposits in branches are protected by the DGS of the home country (instead of the host country) may prove problematic in case of adverse financial developments in the home country since depositors in the host country might worry about the access to, and the adequacy of, the DGS. These concerns have in principle been addressed by Directive 2014/49/EU on DGS, yet it remains to be seen how the legislation would work in practice.

99 As reciprocation of the CCyB in excess of 2.5% is subject to recommendation ESRB/2014/1 and not subject to recommendation ESRB/2015/2, voluntary reciprocity is recommended without any reference to a potential de minimis principle and related materiality threshold.

100 For example, if borrower-based measures are introduced through a product regulation, branches providing services in the host country are bound by these measures as well.

101 See Section 9.
competent authority, but with the macroprudential authority as well. Moreover, the macroprudential authority might need different data than the competent authority given their different mandates and such data needs might differ from one Member State to another based on the systemic risks each faces.

The sound treatment of branches in the area of resolution represents another policy area with a financial stability dimension. The EU resolution framework might include coordination with macroprudential authorities regarding systemically important institutions. The EU resolution framework was introduced in 2014 by the Bank Recovery and Resolution Directive (BRRD) in order to ensure smooth resolution of failing entities including SIIs. The framework includes high-level safeguards such that the home resolution authority should duly take into account the impact of the bank on countries where it has significant branches. However, for the time being, the macroprudential authority is not involved in this assessment, nor does it have the right to designate significant branches. It is important that the optimal resolution strategy reflects the systemic risk posed by individual parts of the group.

Finally, a stronger cooperation framework between home and host competent, macroprudential and resolution authorities is warranted to ensure financial stability. The planned relocation of Nordea headquarters from Sweden to Finland following the group’s branchification in early 2017 points to the need for close cooperation between all authorities to avoid regulatory arbitrage and to mitigate systemic risk. First, cooperation needs to ensure that macroprudential authorities have access to all relevant data for identification and assessment of systemic risks. Second, macroprudential authorities should also be mandated to designate (either solely or together with microprudential supervisors) significant branches and be involved in the development of their resolution plans. Third, cooperation should ensure that systemic risks are sufficiently covered by the reciprocation of the macroprudential measures taken by the host authority.

The Memorandum of Understanding on supervision of significant branches in the Nordic region provides an example of the development of a coordination framework intended to facilitate cooperation between competent authorities in the region. Given the presence of a number of significant branches of several large Nordic banking groups in Denmark, Finland, Norway and Sweden, Finanstilsynet (Denmark), Finanssivalvonta (Finland), Finanstilsynet (Norway), Finansinspektionen (Sweden) and the European Central Bank signed the Memorandum of Understanding in December 2016 with the objective of intensifying the collaboration between the supervisors of the host and home Member States. In June 2017, this Memorandum was also accessed by the competent authorities of Estonia, Iceland, Latvia, and Lithuania.

The Memorandum contains elements designed to facilitate the supervision of cross-border groups with significant branches, including from the macroprudential perspective. For example, by acknowledging the general principle of full reciprocity, the agreement reaches beyond the reciprocity benchmark as laid out in ESRB Recommendation ESRB/2015/2. The Memorandum also explicitly addresses large branches which, if they were subsidiaries, would be considered by the competent authority of the host Member State to be systemically important credit institutions. In particular, large branches are subject to the highest level of cooperation, extensive information

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103 For details see https://www.finanstilsynet.dk/~/media/Om-os/2016/mou-filialer-nordiske-lande-2016-12-19n.pdf?la=da.
sharing, liquidity arrangements, information exchange with respect to internal models with material impact on large branch exposures, as well as recovery planning.

A.4 Conclusions

The choice of the form of cross-border activities is a fundamental right of financial groups. Nevertheless, an effective macroprudential framework addressing the concerns of both home and host authorities is needed regardless of the organisational choices made by financial institutions. The ESRB has already provided an important contribution in this area through the adoption of its framework for voluntary reciprocity of macroprudential measures. The ESRB will continue to support further work on how macroprudential policy can also be effectively conducted in a branch-based environment.