

## The ECB in a Hybrid Banking Union<sup>1</sup>

**Presented at the Conference of the Council for European Studies, Sciences Po, Paris, 8-10 July 2015.**

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### ABSTRACT

International actors promoted the transfer of regulatory authority and financial resources from national governments to the European Union in the context of establishing the prerequisites for financial stability in Europe through banking union. It was supplied, however, by a political process that kept significant resources in resolution and deposit insurance largely in national hands. This paper examines the politics behind those decisions, and how the hybrid of European and national competences affects bank regulation and financial stability in the EU. It concludes that the tension between strong EU supervisory powers and weak capacity to deal with insolvent institutions will persist.

**Keywords:**

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<sup>1</sup> An amended version of this paper, under a different title, is forthcoming in *Journal of Banking Regulation*.

## INTRODUCTION

Banking union in Europe, like economic and monetary union, is incomplete. Its competing legal and political principles stress the transfer of authority to the European level in one area (bank supervision for systemically important institutions) and the retrenchment of responsible national sovereignty on the other (deposit insurance, plus the retention of wide-ranging resolution powers in a new European framework and public backstops), despite support from an international coalition of expert bodies urging the establishment of mutually-reinforcing institutions for financial stability at the European level. Banking union's existing structure therefore does not eliminate the negative feedback loop between insolvent banks and sovereigns that banking union was meant to address. The main backstop keeping the euro zone together during periods of stress will then be outside the EU, in the ESM. This paper contends that the key reason for this development is one of distributional conflicts coupled with power politics. Germany, the Netherlands and Finland resisted calls from France, Ireland and Southern Europe to establish common deposit insurance and resolution funds, plus common public backstops that would have made them net payers and the latter countries net recipients. The construction of banking union serves the interests of the payers best, supporting strong supervision and resolution that minimizes public costs, while making national authorities largely responsible for public backstops, and protecting most national deposit insurance and resolution systems. Despite this, ECB initiatives have proved crucial to building out the central bank's power to intervene. A crucial ECJ judgement provided backing for such moves in June 2015 on the basis that extraordinary measures to provide liquidity to states and banking systems are legal under extraordinary circumstances, such as those the euro zone found itself in 2015.

The rest of this article is structured as follows. Section two outlines the demand for deposit insurance and resolution systems in supplying financial stability, and discusses related aspects of bank supervision as promoted in expert international fora. Section three briefly reviews theoretical considerations of supplying such institutions internationally. Section four unpacks the positions and

motivations of key actors in supplying the institutions of banking union. Section five reviews the evidence and draws conclusions.

### **DEPOSIT INSURANCE, RESOLUTION, SUPERVISION AND FINANCIAL STABILITY**

Banking union can be assessed in terms of how well it supplies financial stability. Financial stability refers to the capacity of banks (and other financial institutions) to meet the demands of their creditors and depositors on a daily basis. Deposit insurance generates financial stability directly and indirectly, while resolution operates directly. Direct measures ensure that specific banks can either be saved from collapse or closed safely if necessary by resolution authorities. Indirect measures benefit depositors and the banking system at large. Deposit insurance forestalls bank runs by instilling depositor confidence that their funds are safe regardless of what bank they do business with, ideally before questions arise about the capacity of a specific bank to meet its obligations and the impact on other banks. Both direct and indirect measures are necessary to contain bank collapses and prevent them from spreading, as are complementary roles for deposit guarantee systems, which prevent bank collapses before they begin, and resolution systems, which prevent collapses from spreading to other institutions (contagion). The capacity of both, in turn, depends on strong pre-crisis supervision that minimizes demand to deploy these tools. The European Commission and ECB considered all three to be essential components of post-crisis financial stability reforms. The rest of this section unpacks deposit insurance, resolution and supervision, including state of the art changes in thinking about how they must be structured and deployed to have sufficient and maximum impact, adding how that translated into advocacy at the EU level. This sets the stage for the next section, which examines how European efforts to establish such measures fared, and why.

## Deposit Guarantees and Financial Stability

The International Association of Deposit Insurers (IADI), plus the Academic Advisory Committee of the European Systemic Review Board (ESRB) and a few other actors have underlined the importance of well thought-out deposit insurance for financial stability. Deposit guarantee systems require a number of attributes if they are to contribute to financial stability. *Broad protection of depositors* ensures that bank clients do not panic when a bank collapse is feared or underway and shift their deposits elsewhere. International best practice covers 90-95% of depositors (not deposits) and all banks to minimise the likelihood of bank runs. The costs of covering so many depositors is contained by limiting the amount of insurance each depositor enjoys.<sup>2</sup> This has a dual effect of preventing mass panic and giving professional depositors the incentive to monitor the bank's behaviour closely.<sup>3</sup> *Information* and a system that is not too complex is also required to make the coverage effective. Public awareness of coverage and reimbursement methods and times are also important to prevent runs.<sup>4</sup> Finally, *timely intervention*, including the infrastructure and capacity to reimburse depositors within a week must be in place before a crisis ensues to forestall depositor runs before they occur to avoid panic.<sup>5</sup>

Beyond coverage, information and timely intervention, deposit insurance requires independent, dedicated funds that are funded by banks in advance of a crisis and replenished after the crisis has passed. *Ex ante funding* ensures that banks are not called on to contribute to a fund at the moment when they are least able to do so, leaving the public purse to pay the bill. The use of the reserve during an economic downturn affecting one or many banks also has a beneficial macroeconomic impact, of acting in a countercyclical fashion that softens the blow of economic downturn and makes

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<sup>2</sup> Reidhill 2013.

<sup>3</sup> The expectation is that such creditors will exercise market discipline by moving their deposits to another bank when they see that the bank is acting too risky for their comfort. The same principle applies to unsecured creditors in resolution situations, discussed below.

<sup>4</sup> IADI 2013: 4-6. Reidhill 2013.

<sup>5</sup> Reidhill 2013.

a faster, more robust recovery possible. Replenishment, which is also ex ante funding for the next crisis, ensures that banks, rather than taxpayers, continue to be the primary paymasters of deposit insurance (the *polluter pays principle*). The intent is not simply to save public money, but to *combat moral hazard* by giving banks and their stakeholders (shareholders, creditors and employees) an incentive to monitor their own risk of collapse and restrain reckless behaviour.<sup>6</sup> Deposit guarantees can be applied to more than cash deposits depending on how balances are kept. Money market funds experienced a run after the collapse of Lehman, for example, as most deposits were kept in that form.<sup>7</sup>

Beyond ex ante funding by banks, deposit insurance also requires an open-ended *public backstop* to deal with the collapse of multiple banks simultaneously that would otherwise bankrupt the deposit insurance fund and hurt the economy more broadly, a position supported by the ESRB.<sup>8</sup> This backstop, like deposit insurance itself, would have to be established at the European level to ensure financial stability for an integrated and interdependent European banking market. Otherwise, the mismatch between pan-European bank activity and the capacity of national DGSs to cope with collapses will continue to be aggravated by the unequal capacity of EU Member States to provide financial guarantees that reinforce national deposit guarantee systems.<sup>9</sup> In the absence of a fiscal union that some analysts consider essential to providing this public backstop, an independent fund backed by the Member States like the European Stability Mechanism, with sufficient funds, and the capacity to leverage its assets through the issue of euro bonds is considered the next best option.<sup>10</sup> However, the ESM itself is designed to be used sparingly, to reinforce national responsibility for financial stability, and to reflect German veto power on the board.

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<sup>6</sup> Datwati 2013.

<sup>7</sup> ESRB 2012: 17-18.

<sup>8</sup> ESRB 2012: 18, FSB 2012.

<sup>9</sup> Donnelly 2014.

<sup>10</sup> Wolff 2013.

## **Resolution and Financial Stability**

Resolution has two key functions during a bank crisis: to ensure the continuity of financial services for normal bank clients, even when that must happen at a new bank, and to minimize the impact of the bank's closure on other banks. Resolution involves the appointment of a manager for the bank who winds up the institution by prioritizing who gets whatever money is left in the bank, forthcoming from deposit or resolution insurance and otherwise claimable from other counterparties.

Counterparties are other institutions with which the bank transacts, which may have outstanding claims on or debts to the bank under administration. Resolution not only sorts out the position of retail depositors, who are covered at least in part by deposit insurance, but also of commercial ones who are not, including other banks who may owe the defunct bank money. Optimally, a resolution authority can restructure the bank before a collapse actually occurs, leaving behind a smaller, but healthier and viable institution. Resolution therefore overlaps with supervision, which is responsible for ensuring that banks avoid behaviour leading to failure, or issuing an early warning for corrective action if a bank gets into trouble. A specific overlap may be a demand for banks to increase their capital or liquidity buffers to better withstand the collapse of other banks. The latter has happened in Cyprus and in Greece. Resolution has two key functions during a bank crisis: to ensure the continuity of financial services for normal bank clients, even when that must happen at a new bank, and to minimize the impact of the bank's closure on other banks.

The most important of resolution authority mechanisms for fulfilling the functions mentioned above is restructuring bank assets. The way in which this is done affects the cost to creditors, to the resolution fund, and to the public sector backstop that provides for additional capital in winding up the bank so that it does not threaten other institutions. Divergent national practices and authorities matter therefore, making a single approach and authority crucial for an integrated market.

Resolution authorities employ three restructuring methods: separation of assets; transfer of business; and bail-ins. Separation of assets removes toxic assets (non-performing loans or exposures

via other financial instruments that have a negligible market value) from the bank. On the bank's financial records, this replaces a fictional display of healthy income and wealth with a realistic assessment, which may approach zero. Transfer of business sells what is left of the bank to another bank, normally after asset separation. A public entity known as a bridge bank may hold on to what is left until a buyer can be found. Finally, resolution authorities may execute bail-ins by terminating or altering the contracts that the bank has with its creditors. These creditors are typically other institutional investors such as pension funds, hedge funds, mutual funds, money market funds and other banks. Resolution authorities may attempt to ensure that the bail-in compensates as much as possible for the writing down of toxic assets. What remains of the bank is a much smaller institution stripped of most of its assets and liabilities that can be transferred to another bank as it is closed as an independent business.

The need for a resolution fund occurs at the point where a bail-in large enough to compensate for the write-down of toxic assets exceeds the capacity of the further financial system to absorb and endangers financial stability. The resolution fund contains the severity of the bail-in, so that what remains of the bank (primarily insured deposits and remaining safe assets) can be transferred to a new owner without threatening the solvency of the bank's creditors.

The alternative to bail-ins by private creditors, or a supplement thereof through the resolution fund, is a bail-out with public funds. Although bail-ins were uncommon and bail-outs widespread at the beginning of the financial crisis, bail-ins have gained traction in global circles as necessary to counter the incentive for large banks to engage in moral hazard by increasing creditor vigilance alongside stronger supervision. Institutional investors would have greater incentives to sit on boards of directors, insist on more transparent reporting and regular controls in ways that retail depositors

cannot.<sup>11</sup> Bail-ins also reduce to some extent the possibility that bailing out an insolvent bank could bankrupt the state providing the bailout.

As with deposit guarantee systems, there are also clear functional reasons for setting up an independent resolution authority and fund before a crisis erupts. Uninsured depositors and creditors need to know that the resolution authority can and will impose losses on them in the event of insolvency to increase the incentive to monitor the bank diligently, in cooperation with supervisory authorities.<sup>12</sup> Similar argumentation is also found in the European context. Gros and Schoenmaker argue for the establishment of a European Deposit Insurer and Resolution Authority.<sup>13</sup>

In this context, the European Central Bank underlined the need for a European Resolution Fund and Authority, coupled with deposit insurance, if it were to effectively break the negative feedback loop between bank debts and public sector debts in Europe. To do this, a Single Resolution Authority was required with the power to close a bank swiftly (in the interest of preventing contagion that could damage financial stability) and impartially (to ensure that investors from different member states are treated equally). It also would require access to a single resolution fund and to additional public funding at the European level in the course of a systemic crisis.<sup>14</sup> The ECB underlined that a coordination of national resolution authorities would not provide financial stability properly.<sup>15</sup>

The ECB and ESRB also concurred with international experts on other details of institutional complementarity. They outlined that resolution funds must draw on deposit insurance funds to contribute to the costs of winding down and bank and ensuring the continuity of critical functions for the broader economy. To minimize the use of public funds in resolution proceedings, private actors should be expected to contribute first (unsecured creditors and insured deposits), followed by a

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<sup>11</sup> Mayes 2013.

<sup>12</sup> Reidhill 2013.

<sup>13</sup> Gros and Schoenmaker 2012.

<sup>14</sup> Coeuré 2013.

<sup>15</sup> Coeuré 2013.

resolution fund that banks pay for themselves, coupled with contributions from DGSs, and only then via a public sector backstop that would extend loans to the resolution fund. The fund would then repay those loans after the resolution and collect the balance from insured banks. The Scientific Advisory Committee of the European Systemic Risk Board concurred, stressing specific aspects for European financial stability. It emphasised the need for ex ante funds, as asking banks for capital during a crisis would be countercyclical for the general economy and impractical when banks lack the capital to pay.<sup>16</sup> It also urged the establishment of a Single Resolution Authority and Fund as necessary to overcome the mismatch between home country control as a principle of assigning competence, and the impact on various subsidiaries in the firm, especially those operating in different countries, to deal with cross-border shifts in deposits during a crisis, and to deal with the impact of a weak state being inundated by claims against a national resolution fund and/or deposit guarantee system.<sup>17</sup> The Committee therefore viewed a combination of supervision, resolution and deposit insurance as necessary at the European level, coupled with access to the ESM as a public backstop and expressed concern that early Council plans for banking union had made no mention of such.<sup>18</sup> It went even further by arguing that resolution powers had to be sufficiently robust to ensure that public authorities could step in, take control, sort out the business and then restructure, recapitalise and reprivatize the good parts of the businesses,<sup>19</sup> as Swedish authorities did in the early 1990s.

In the absence of common deposit insurance and resolution systems, the next best option is to coordinate national systems and pool funds. Early Commission proposals for a European deposit guarantee system therefore included measures to ensure minimum coverage standards and cross-border transfer of data and home/host mutual assistance.<sup>20</sup> Coordination protocols focussed on

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<sup>16</sup> ESRB 2012: 14.

<sup>17</sup> ESRB 2012: 20-21.

<sup>18</sup> ESRB 2012: 22-25.

<sup>19</sup> ESRB 2012: 11.

<sup>20</sup> Kuczynski 2013.

cross-border payment, communication and public awareness, including issues of deposit coverage (scope and limits), payment methods and timing, in order to manage public expectations and avoid panic.<sup>21</sup> Suggestions to pool funds were made in 2010 and 2014.

### **Supervision, Moral Hazard and System Design**

Bank supervision oversees the business activities of banks in accordance with regulatory law and standards, provides guidance, generates technical requirements and enforces compliance where necessary. Supervision ultimately promotes financial stability by ensuring that banks have sufficient liquidity on hand to meet demand, supported by requirements that ensure their ongoing solvency (asset quality, capital ratios, net stable funding ratios, leverage ratios and stress tests that model the impact of negative shocks on bank viability). The costs to banks, as evidenced by stress tests in Europe and the United States, are considerable.

An initial concern for financial stability in Europe prior to banking union, with its fragmented political and regulatory structure, was that uneven application of supervision or outright forbearance by national supervisors confronted with distressed banks could distort competitiveness and competition and delay the exposure and cleaning up of toxic assets in the European banking market. The results would not only be felt in the continuing presence of zombie banks, which drag the economy down by soaking up capital without generating new credit, but in continuing uncertainty in Europe over how much cleaning up the banks would cost. This made discussions of burden sharing difficult, indeed impossible. One of the intended consequences of transferring supervision to the European level were therefore to provide a robust and even intervention into the European banking sector, so that it could begin with a clean slate after the financial crisis, with confidence that forbearance and uneven application would not generate new crises. The Bank for International Settlements and the Academic

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<sup>21</sup> Fekete-Györ 2013.

Committee of the ESRB underlined strongly the need for a common supervisor that could prevent national forbearance.<sup>22</sup> Looking forward, the BIS noted that the need to look soberly at bank balance sheets, force corrective action on an ongoing basis would also become particularly important when quantitative easing is tapered to the extent that banks can no longer hide the extent of impaired assets,<sup>23</sup> and when national governments (some more than others: program countries in Southern Europe being the weakest) are incapable of providing capital injections to recapitalize banks in a crisis.<sup>24</sup> Robust supervision would therefore reduce the future likelihood of collapses putting pressure on resolution and deposit insurance systems.

The Centre for European Policy Studies (CEPS) added that a full banking union package could pave the way to global regulatory convergence on leverage ratios, further enhancing financial stability. They advocated focusing on overall leverage levels within the bank, which the FDIC employs as a measure that is objective, transparent and linked to the overall risk attached to individual banks, rather than the risk-weighted averages typically employed in Europe and in the Basel Accords. The FDIC shuns risk weights as prone to creative interpretation by banks and credit rating agencies, which undermines the usefulness of such information in assessing when a bank is at severe risk of failure or actually insolvent.<sup>25</sup> CEPS hoped that a strong ECB could start forcing down leverage levels in European banks that remain five to six times higher than in the United States on average. American regulators forced down bank leverage levels after 2008, whereas their European counterparts did not, as they issued more debt to keep them afloat, particularly in the euro zone.

All of these points are clear expressions of intent by ECB, ESRB and global actors (IMF, IADI) in favour of centralized institutions in all three areas. Strikingly absent is the European Commission, which

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<sup>22</sup> ESRB 2012: 5, 42.

<sup>23</sup> BIS 2011: 42.

<sup>24</sup> BIS 2011: 57, 72-83.

<sup>25</sup> Reidhill 2013.

although pushing for solutions, modelled its proposals on lines that protected the prerogatives of the Member States. The politics of responding to such pressures are analysed below.

### **Public Backstops**

While broad agreement was established in the context of the Great Financial Crisis that public backstops for banks were required in the areas outlined above, some analysts advocated the establishment of a fiscal union to assist governments when EMU was constructed. That issue went away with the political rejection of fiscal transfers in the early 1990s, but returned as a lesson from the euro zone crisis of the 2010s. Given that EMU's rules had asymmetric effects on economic growth when they were respected and enforced<sup>26</sup>, a fiscal union would put a floor under national financial stability. The resulting positive macroeconomic impact in the euro zone's periphery would relieve pressure on national banking systems and national finances simultaneously.

In the absence of such mechanisms, the euro zone fell as predicted into a state of unsustainable volatility and contraction during the crisis years, which the ECB then alleviated through extraordinary measures unforeseen in the Treaties. These are discussed below.

### **THEORETICAL CONSIDERATIONS OF SUPPLYING BANKING UNION**

While the section above shows a number of key incentives to establish resolution, deposit insurance and supervisory systems, the EU elected to coordinate national deposit insurance and resolution

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<sup>26</sup> Although neglected, pressure increased through the European Semester, the Six Pack and Two Pack for the euro zone, and the Treaty on Stability, Coordination and Governance (TSCG) after the onset of the euro zone crisis.

systems and minimize the relevance of an (automatic) European public backstop to the respective funds. To shed light on why, it is useful to look for conflicts between Member States, whether real or potential, and between them and the European institutions they reject, particularly the ECB and the ESRB.

Theoretically and practically, the supply of European institutions is best explained by the intergovernmental nature of the EU decision-making process in establishing new institutions.<sup>27</sup> That view maintains that international negotiations on institutional development, cooperation and pooled resources are dominated by national governments who focus on the distribution of resources across countries, and exercise power to the extent that they can to secure the best outcome possible for themselves. Consequences for others are of a lesser order priority. If true, then even functional demand for institutions that involves significant transfers of resources across borders and regulatory authority to the supranational level should be limited to voluntary measures<sup>28</sup> and coordination through networks of national competent authorities that preserve national autonomy<sup>29</sup> with minimal impact on those with the greatest power resources. In negotiations involving multiple projects with potential compensation of losses in one area with gains in another, deals are possible, but agreements will reflect the preferences of the most powerful, and with the strongest unilateral alternatives.<sup>30</sup>

The alternate hypothesis, based on either a liberal institutionalist theory of international relations or neofunctional theory of European integration is that functional incentives, in this case to provide financial stability for an integrated banking market, will create pressures for national governments to create European level institutions, supported by existing supranational actors (EU and other institutions), private transnational coalitions (of banks doing business in multiple EU states) and

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<sup>27</sup> Quaglia 2007.

<sup>28</sup> Brummer 2012.

<sup>29</sup> Mosley 2000, Weiss 1998, Walter 2008, Kapstein 1994.

<sup>30</sup> Grieco 1988. Drezner 2007.

possibly transgovernmental networks. Positive welfare gains sufficient to induce cooperation include insurance against potential loss. Insurance and regulation are shifted to the same level of activity as those of economic actors to avoid a suboptimal capacity to handle risks. A liberal institutionalist or neofunctional view also expects pooled or common financial resources to combat threats to financial stability where they are greatest to preserve and integrated, interdependent banking market. Intergovernmentalism expects the deliberate reinforcement of national responsibility so that financial stability in the broader banking market declines.

## **SUPPLYING BANKING UNION**

### **European DGS**

Despite the functional necessities of establishing DG and resolution systems at the European level to handle the financial risk of banks operating across European borders, there are a number of thorny distributional issues that complicated international negotiations-- whether national governments or Europe collectively provide a public backstop, and whether banks should all pay equally into the system, regardless of their risk profile. Net contributor countries have an incentive to minimize costs by ensuring that private actors pay as much as possible, and that the collective funds are kept smaller rather than larger. They should also be concerned that asymmetric benefits to countries with the weakest banking sectors encourage moral hazard, and damage the competitiveness of their own banks.<sup>31</sup> These concerns indeed led Germany, the Netherlands and Finland to reject European deposit insurance funds, reject the right of national funds to borrow from one another in an emergency, and restricted use of European Stability Mechanism funds for insolvent banks when deposit insurance had run out.<sup>32</sup>

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<sup>31</sup> IADI 2013: 5-7.

<sup>32</sup> Stahlhut 2012.

An additional issue for national deposit insurance systems in Europe with distributional consequences is the coordination of national practices in the absence of EU institutions. This extends not only to the technicalities of sorting out who pays and how in the event of bankruptcy affecting depositors in more than one country, but the issue of beggar-thy-neighbour policies that force other states to spend more on deposit insurance. The Irish introduction of unlimited deposit insurance in 2008 without consulting other EU Member States, was viewed in other European capitals and in Brussels as such an act, as it threatened capital flight out of other countries into Ireland until other countries followed suit and provided greater deposit guarantees. It was therefore easy to find agreement in the Council to improve coordination and information across countries, which might slow down or prevent similar situations from occurring in the future.

The initial response of the European Commission regarding deposit guarantee systems came in 2008, and was limited to modest technical measures to enhance efficiency in national systems. The draft directive proposed to shorten the payout times for depositors (to three days from three to nine months) to increase the amount covered (from 20 000 euros to 100 000) and to mandate cooperation between national systems in an unspecified manner.<sup>33</sup>

Subsequent bank failures during the 2010 onset of the euro zone crisis led to a reformulation of the draft directive, this time targeting financial and other cooperation across national systems, to address the chronic instabilities of southern Europe in particular. The Council agreed to minimum standards for national systems and providing for coordination between them, but not to introducing European deposit guarantees. Coordination measures were designed both to prevent the Irish scenario from repeating itself--coverage for deposits shifted across borders after the point of failure would not be possible,<sup>34</sup>--and to prevent northern European systems from having to pay for the collapse of southern European banks with branches in the north, by ensuring that national deposit

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<sup>33</sup> European Commission 2008.

<sup>34</sup> Council 2011: 6.

insurance systems of a bank's home jurisdiction would ultimately cover liabilities in other EU Member States.<sup>35</sup> National governments would then be responsible individually for shortfalls in the system as the public backstop. These details strengthen, not weaken the link between national governments, DGS and banks headquartered in their jurisdictions.<sup>36</sup> Commission plans to require risk-weighted premiums were rejected in favour of Member States deciding how to charge banks.<sup>37</sup> Similarly, most European Parliament demands fell by the wayside. However, they did secure 100 000 euros standard coverage.<sup>38</sup>

The Commission tabled a new European DGS proposal in September 2012 as it prepared legislation regulating bank resolutions to reflect an emerging consensus among deposit insurers that deposit insurance funds should be deployed as part of bank resolution. The logic that the DGSs would pay out less if helping to prevent a failure than in reimbursing depositors for an actual collapse reflected the state of the art in maximizing the contribution of deposit guarantee funds to financial stability. Given the willingness of European states to pass the resolution legislation, it appeared an opportune moment to secure agreement on deposit insurance. However, the continued prospect of cross-border transfers led northern European states to block an agreement. The proposed right to borrow across national DGSs was expressed again as an option,<sup>39</sup> and then withdrawn entirely in a later Commission proposal, following German objections.<sup>40</sup> The revised proposal was considered insufficient by a number of outside specialists. Rather than national coordination, the IMF made it clear that a truly European DGS was essential for financial stability (IMF 2013: 11).

An alternative from Gros and Schoenmaker attempted to secure agreement despite these concerns by lowering the prospect of immediate transfers between states and lowering transaction costs for

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<sup>35</sup> Council 2011: 21.

<sup>36</sup> Kapstein 1994.

<sup>37</sup> Council 2011: 10.

<sup>38</sup> European Parliament 2012.

<sup>39</sup> Council 2011: 31.

<sup>40</sup> Binder 2013.

states without ex ante funded systems. They argued for a combined European Deposit Insurer and Resolution Authority whose powers and funds would be phased in to take over from national authorities and ex ante funds over a 20-year period. The European authority and funds they proposed would initially exist alongside national schemes and then gradually assume responsibility for losses over a 20-year period. Countries with ex ante systems would transfer assets gradually to the European system, while countries with ex post systems, like the Netherlands, would build up their contributions over time.<sup>41</sup>

Gros and Schoenmaker also tried to minimize the concern of Germany and others likely to have to be net payers into a transfer system that feared paying for the toxic assets of foreign banks. They argued that only well-capitalized banks should enter the system, so that the fund's establishment would not make large transfers to cover past losses (legacy problems). Those debts will need to remain national problems.

The Gros/Schoenmaker plan hoped that zombie banks could be cleared up in an orderly fashion and distributional concerns regarding unknown liabilities across countries be resolved simultaneously. It therefore dovetailed with Germany's demand that European deposit insurance or resolution funds could only be considered after the establishment of the ECB as the single supervisor for the European banking system.<sup>42</sup> As Gros and Schoenmaker underline, however, supervision equally requires strong resolution and deposit guarantee systems.

Nevertheless, the Council remained firm on its plan for coordinated national approach coupled with minimal cross-border transfers at the discretion of Member States. The DGS Directive (2014/49/EU) opted to set minimum standards for national DGS, and to coordinate their use in cross-border insolvencies. It provides exemptions for certain categories of banks, such as credit unions, public sector savings banks and banking cooperatives, which the German government had defended

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<sup>41</sup> Gros and Schoenmaker 2012.

<sup>42</sup> Financial Times 2012.

heavily.<sup>43</sup> Deposit insurance can be used in resolution proceedings, but borrowing across DGS systems is entirely voluntary. This results in an undersupply of financial stability when measured against the requirements of banking sector officials discussed above.

The discretion of member state governments in granting loans to the DGSs of other countries reflects not only an undersupply of the public backstop to deposit guarantees, but an asymmetric one at the European level. Countries with higher credit ratings enjoy a stronger capacity to borrow to shore up their systems in an emergency, meaning that in order to ensure appropriate buffers, the banking systems of financially weaker countries would be forced to reduce their balance sheets more vigorously than elsewhere. It also ensures that the EU's more financially powerful countries are more fully capable of coercing national governments faced with a failing bank to close it against their will. Germany, the Netherlands and Finland recognized and showed in the 2013 Cyprus bank crisis that they would not share costs in a deposit guarantee system, but rather use Cyprus' incapacity to pay to exert pressure on ESM recipient countries to restructure and resolve banks without resort to common European resources. The resolve of the head of the euro group, Dijsselbloem, underlined that he was willing to undermine confidence in deposit insurance as a whole throughout Europe, and thereby the effectiveness of financial stability measures overall, in the process of coercing restructuring of the Cypriot banking sector.<sup>44</sup>

As Gros and Schoemaker suggested, Germany, the Netherlands and Finland adopted the position, and later the eurogroup, that national governments would have to take responsibility for legacy debts of national banks made before any European resolution mechanism would enter into force, thereby blocking recapitalization of Southern European and Irish banks by their northern European neighbours, as the potential recipients had requested.<sup>45</sup> Financial assistance through the ESM would only be possible in resolution and restructuring cases that shut banks down, discussed below. Given

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<sup>43</sup> Stahlhut 2012.

<sup>44</sup> Campbell 2013.

<sup>45</sup> Walsh 2013.

the dominance of the German coalition within the ESM, funding would therefore only be negotiable for future crises, and only when the recipients accepted eurogroup demands on when and how a bank is to be closed, as in the Cyprus case.<sup>46</sup>

### **European Resolution**

The introduction of the Single Resolution Mechanism in the EU fell significantly short of BIS, IMF, ECB and ESRB expectations, and short of the achievements secured in the Single Supervisory Mechanism. The political and legislative process necessitated working through issues of national harmonisation and coordination first as the parties determined how far they could go with regard to the establishment of a European Resolution Authority (ERA) and Fund. The first tasks were handled in the Bank Restructuring and Resolution Directive (BRRD, 2014/59/EU), while the authority and fund were handled in the Single Resolution Mechanism Regulation and an intergovernmental agreement outside the EU establishing the Resolution Fund once it became clear that they would be required for resolution to work.

The draft BRRD was tabled in June 2012, three months before the proposal for the Single Supervisor Mechanism, but concluded only in May 2014, due to hesitancy in Council over whether European powers were needed, and what common standards of resolution should apply. Like the DGS Directive, it first attempted to coordinate national systems and harmonize certain elements rather than establish a European authority and fund.

The implications of resolution were clear to national governments, as evidenced in Council documents. They acknowledged that the powers of a resolution authority can be wide-ranging, affecting the power of not only creditors, but of its shareholders and owners through the transfer of business (to another company or bridge institution), selling assets within the group without the

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<sup>46</sup> Hadjipapas 2013, Spiegel 2013.

approval of shareholders if necessary.<sup>47</sup> However, their response to the draft insisted that the BRRD respect the principles of European company law.<sup>48</sup> This impedes resolution involving the parts of a bank or an entire bank from one EU member state to another, given that EU company law allows Member States to place effective impediments to the migration of a company out of its jurisdiction.<sup>49</sup>

Some of the Council's deliberations focused on technicalities of coordination between national authorities (information sharing and setting up resolution colleges for cross-border cases). Others focused on setting minimum standards for national resolution laws, authorities and funds. They agreed that Member States should appoint independent resolution authorities, ensure their involvement in resolution along guidelines set out by the European Banking Authority,<sup>50</sup> but also to resolve banks as much as possible without extraordinary public support, including finance from the general budget.<sup>51</sup> This expectation reverberates with arrangements made by euro zone Member States for the European Stability Mechanism in 2013 that any ESM loans made to a country for resolution purposes must honour the principle of minimizing the size of the public backstop. Resolving banks with a minimum of public support (bail-out) and maximizing the cost paid by private actors (bail-in) was demanded by the Netherlands and Germany at the head of the euro group, and opposed by governments in Southern Europe, France and Ireland. Nevertheless, finance ministers were to be involved in resolution proceedings. This underlines that the Council's concerns were about public expenditure far more than ensuring independent control by resolution authorities, as technical experts had advocated.

Bail-ins nevertheless raised national differences in algorithms--how to choose which private investors should suffer first and most--which took time to resolve. Although the ECB urged Member States to

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<sup>47</sup> Council 2013a: 19, 25.

<sup>48</sup> Council 2013a: 37.

<sup>49</sup> Donnelly, 2010.

<sup>50</sup> Council 2013: 7-8.

<sup>51</sup> Council 2013: 11, 15, 23, 33.

decide on one list, the Council initially could not come to an agreement on a single standard.<sup>52</sup> It also deferred the requirement for countries to put bail-ins before bailouts until 2019. Although the euro group could coerce such a choice for Cyprus at the moment of insolvency, it was not able to do so for countries dealing with banks that were not on the brink.

The BRRD's final format ensured that shareholders would suffer the first losses, followed by unsecured creditors, with covered deposits enjoying the highest level of protection.<sup>53</sup> National authorities would be able to make further exceptions to classes of creditors during a bail-in on a case by case basis in conformity with national resolution law where imposing a haircut would prevent the provision of 'critical functions', would unleash further contagion, or impose losses on other creditors. While the later passage of the SRM Regulation placed an additional layer of European supervision on top of this national process (discussed below), national authorities remain largely in control of the details that matter most in a resolution, such as the detailed pecking order of claims and exemptions.

The ECB critiqued the Council's decision to wait until 2019 for the bail-in provisions of the draft directive to take effect. Resolution authorities would lack one of the most important tools in being able to do their jobs, which would undermine the intent of the BRRD.<sup>54</sup> It also argued that the discretion of national law and authorities could generate legal uncertainty for investors, supervisors and others in addition to making forbearance possible. It levelled the same critique against the lack of rules regarding the pecking order of creditors who would be called on to contribute to a bail-in. This would create an incentive for political manoeuvring at the national level, making bail-ins work differently from country to country, and more slowly. One could also say it engineers room for

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<sup>52</sup> Council 2013a: 12.

<sup>53</sup> Council 2013a: 2.

<sup>54</sup> Asmussen 2013.

national governments to defect from common rules in order to protect banks for nationalist purposes, where nationalist means on the grounds that the bank is valued as a national resource.<sup>55</sup>

The issue of which national resolution authority or authorities would have the power to direct such matters was also an issue for dealing with multinational banks. As with deposit insurance, the issue was decided by assigning resolution authority for all parts of the bank and its subsidiaries to the country in which the bank is headquartered.<sup>56</sup> Although there were provisions to form resolution colleges of multiple national authorities, the Council's position was that lead authority would have the power to act even over the objections of other authorities.<sup>57</sup> This strengthens the power of national authorities supervising the EU's largest multinational banks at the expense of countries served by those banks.<sup>58</sup> This outcome has long-term market advantages for banks headquartered in countries where the sovereigns are best able to provide lender of last resort services in the form of cash injections or debt guarantees—in Germany and a few selected countries allied with it.

Between 2013 and 2014, the Council's position on shared resources shifted meaningfully, particularly with regard to shared resolution funds, but in ways that continued to keep the available funds small and therefore ensure continued reliance on national funds. As late as 2013, the Council had not yet agreed to share resolution fund money across national borders,<sup>59</sup> ex ante funding was still an option rather than a requirement, and the level of funding was half the international standard with assets of 0.8% of covered deposits 10 years after the directive enters into effect (rather than the international norm of 1.5% immediately).<sup>60</sup>

The only agreements in 2013 were demands made by Germany, the Netherlands and Finland that protected existing national systems and reduced the likelihood of public money being used to resolve

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<sup>55</sup> Asmussen 2013.

<sup>56</sup> Council 2013a: 12.

<sup>57</sup> Council 2013a: 30.

<sup>58</sup> Epstein 2008, 2013.

<sup>59</sup> Council 2013a: 3.

<sup>60</sup> Council 2013a: 12, 32.

a bank, nationally or collectively. Banks would be required to pay for the fund, based on liabilities and risk, and countries (like Germany) would be able to make the resolution fund part of deposit insurance or bank insurance, allowing for a minimum of adjustment in national systems. Resolution funds could be used for direct recapitalization, but only after creditors had been forced to take a haircut 8% or more of the bank's liabilities.<sup>61</sup> This restricts the use of resolution funds by EU Member States in protecting their banking sectors.<sup>62</sup> Effectively, the BRRD limited itself to setting the standard for newly established national resolution systems and their coordination. European elements were dealt with in conjunction with the establishment of a European entity for resolution.

The power of what was to be the European resolution authority in 2014 was more than states had agreed to previously, but less than advocates had called for. Instead of an institution modelled on the FDIC, with sweeping powers, the EU established a Single Resolution Board as a layer coordinating and working together with national resolution authorities (NRAs) in recommending resolution of banks to the European Commission and the Member States in the Council. The Board itself, which takes all key decisions, is comprised of five standing board members, plus all of the national resolution authorities of the euro zone (plus any other states that wish to join the system). The Board recommends to the Commission whether a bank should be wound down, and presents that decision together with a resolution plan, which is effectively drawn up by the national resolution authority in question, or in special cases, by the resolution college of two or more national authorities that are significantly affected. Pending approval by Commission and Council, the Board then hands over implementation to the national authority, which proceeds in accordance with national law, which may differ on material matters of importance to creditors. Adding to this already cumbersome and time consuming process is that the Board may not intervene at an earlier stage to put a bank under administration, as

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<sup>61</sup> Council 2013a: 4.

<sup>62</sup> Deeg and Donnelly, forthcoming.

suggested by experts above, but only when collapse had become clearly unavoidable. National powers and laws therefore still remain important.

The third issue was the establishment of a fund, which was set up in such a way that national funds and public backstops will continue to have vital roles to play. The SRM Regulation finally provided the legal means by which deposit insurance funds would be used to supplement resolution funds. It also stipulates the broad terms of the establishment of the Fund, including ex ante funding and replenishment and the gradual mutualisation of the Fund on an accelerated time schedule of eight years rather than 15, so that contributions can flow across national borders, and earlier if required. But the Regulation stipulates that the Fund is to be used as a last resort only, and that the Fund remains outside the EU on the basis of intergovernmental agreement rather than EU law. It also kept the size of the Fund at its original low level of 55 billion euros. This ensures that anything beyond the size of a single large institution would have to be handled by another fund, such as national public backstops or an intervention by the ESM, which provided 100 billion in assistance to Spain in 2012, for comparison, and has a combination of subscriptions and leverage totalling 1 trillion euros.

### **European Supervision**

The distribution of costs and benefits between states in the euro zone (a political motivation), proved even more important than evenness of supervision (a technical motivation) in determining the strength and early establishment of the Single Supervisory Mechanism. Although there were disagreements about how many banks the ECB would supervise directly, Germany and its closest allies on the Council demanded a strong European bank supervisor in exchange for any financial assistance they would provide to other countries. In 2012, this concerned the extension of 100 billion euros in loans to Spain to contain and resolve a mid-level collapse of the savings bank sector. As negotiations over banking union continued, it extended to concerns about the cost of a resolution

system as well. Germany, the Netherlands and Finland cited concerns about moral hazard and unknown financial exposures in the European banking system that might burden them, and expected that a strong supervisor could detect and force the liquidation of toxic assets that might otherwise become liabilities for national governments, resolution and deposit insurance systems, and in turn, for the EU Member States, either as members of a future common resolution fund (which was under discussion) or as contributors to the ESM. Supervision was a much less pressing priority for most other euro zone Member States, particularly those seeking the swift establishment of the ESM in June 2012. However, those euro zone member states accepted the necessity of supervision as the price of accessing a collective public backstop in the ESM that they could not supply themselves individually.<sup>63</sup> The more precarious the banking sector, the more concerned the governments had to be about the potential negative impact of aggressive supervision, but the inability of some governments to rely on bond markets for financing public debt during periods of stress make it plain that they had to accept these terms.<sup>64</sup>

What is remarkable is how strong the ECB turned out to be despite the initial reluctance of Germany, its main supporter, to allow supervision over any but the 25 largest EU banks. The development of an algorithm extending direct coverage to 128 banks, based on a wider definition of systemic importance, was the first successful move taken to expand authority beyond its original mandate. The decision to complement EBA stress tests with its own Asset Quality Review in 2014 was a second successful move. The AQR signalled to banks and supervisors early that the investigation would be more strenuous than previous stress tests run by the EBA, leading most of them to significantly increase capital over the course of 2013, and for those that failed to make the grade, to do so afterward as well. This message apparently only failed to reach Italian banks and supervisors in time,

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<sup>63</sup> Donnelly 2014.

<sup>64</sup> This is underlined by parallel German demands that governments sign the Treaty on Stability, Coordination and Governance, which demands balanced government budgets, in return for access to the ESM. This measure incidentally reduces the capacity of those governments to support their banks during a credit event. Politicians in Ireland, Spain and Portugal referred to the demand as blackmail, but accepted it nevertheless.

given that Italian banks constituted half of all failures. This certainly hardened the ECB's reputation. Nevertheless, German support remained firm throughout. The third move is the development of the single rulebook that national regulators are expected to apply to other banks as well.

This raises the question of whether the Single Resolution Board might develop the same degree of power, and whether that institution and the ECB have power independent of the political backing they enjoy. Even though the Board's powers are less extensive than those of the ECB as the Single Supervisor, given the reluctance of most governments to relinquish involvement in bank affairs,<sup>65</sup> SRB strength is essential in signalling to banks and national supervisors that there are real consequences if banks fail to take precautions to prevent collapse. This has not been tested yet, but the German strategy of keeping cross-border transfers to a minimum and reinforcing incentives to national authorities to keep their houses in order is consistent with continued political backing, and as in the case of supervision, using the ESM to keep political discontents in line. The SRB is therefore likely to be used rarely, but decisively, without serious political challenges.

### **Public Backstops / Lender of Last Resort**

In the context of negative feedback loops between state and bank insolvency in the euro zone crisis, the ECB found itself providing additional liquidity to euro zone governments that had been cut off by financial markets from 2010 (beginning with Greece, then extending to other euro zone periphery countries). Neither of the intergovernmental inventions for dealing with weaknesses in public backstops, the EFSF or the ESM was considered sufficient in practice to ensure that national governments could fully pay the interest on their treasury bills, and that the banks that had bought them remained solvent as well. The EFSF was limited to the first years of the crisis and intended to be temporary, leading financial markets to discount its utility over the long term. The ESM which

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<sup>65</sup> Donnelly 2012.

replaced it suffered from German exhortations that the fund was meant not to be used, and by institutional rules that restricted the disbursement of funds without explicit German approval.

In this context of restricted public backstops, the ECB found its way to providing lender of last resort facilities to governments and banks, in line with international practice but out of line with the treaty provisions that established the bank. The Securities Markets Programme (SMP) bought government treasuries on secondary markets from 2010 onward during periods of sustained high interest rates on government bonds. The Outright Monetary Transactions announcement of 2012 indicated a willingness to purchase those bonds directly from governments in extreme, crisis circumstances. They were not used, but cooled markets nonetheless, allowing national governments to continue borrowing on bond markets. Finally, during the Greek crisis of 2014-5, the ECB provided Emergency Liquidity Assistance to Greek banks: loans to banks against collateral. This collateral often included the treasury bills that might be subject to default or haircut in the event of a Greek state bankruptcy. Like the OMT, it was seen as an extreme measure for emergencies only, and conditioned by the lack of other mechanisms within the EU to provide public backstops for financial stability, and therefore not part of the ECB's regular mission.

This did not go unchallenged, but survived a German Constitutional Court request to the ECJ for a ruling on the ECB's legal right to provide lender of last resort facilities. The Court case, brought forward by members of the conservative CDU and CSU, and supported by orthodox economists such as Hans Werner Sinn of the Munich IfO Institute, challenged both the legal right and the operational judgement of the ECB in extending credit under all three programmes. It also challenged the role of the ECB in providing lender of last resort facilities at all. While the Court agreed that the Treaties banned the direct purchase of government treasuries, and that the question had to be taken seriously whether the ECB was circumventing the spirit of the law (SMP and ELA) if not the letter of it (OMT), it also maintained that the measures were proportionate and reasonable exceptional measures under exceptional circumstances to ensure financial stability for the entire EU. The German

Court case also maintained that the ECB would damage both its financial stability and its political independence by putting these public, and other private assets on its balance sheets. Finally, the plaintiffs argued that the ESM had been created to provide public backstops in emergencies, and that the ECB was therefore explicitly excluded from doing so itself. The ECJ similarly found no real merit in those claims. The ECJ's ruling in June 2015 was a preliminary ruling that the German Constitutional Court in Karlsruhe could choose to pick apart, but as long as crisis conditions in the euro zone remain, the nature of the ECJ's response provides nothing visible in the way of flanks that the plaintiffs could fruitfully attack.

## **CONCLUSIONS**

This paper began with the contention that banking union is built on a tension between strong transfer of supervision to the European level, but significant conservation of national authority in deposit insurance, resolution and provision of public backstops. It suggested that this reinforces the link between national sovereigns and banks that banking union was meant to reduce or eliminate, that this was deliberate, and that ongoing instability in the euro zone would be the result. It also demonstrated, however, that the insufficiency of public backstops for banking union components, and for lender of last resort facilities has led the ECB to step in with its own programmes. The ECJ's blessing strengthens this move considerably.

There is little doubt that the European Central Bank has done its utmost to expand its authority when given the opportunity in important areas and will continue to do so. There are also reasons to believe that the SRB will also be an institution to contend with, though not with as much freedom to innovate as the ECB. The ECB's capacity to extend its mandate puts greater pressure on banks and national regulators and is enhanced by a politically permissive environment, in which the countries

that pay most to bolster national public backstops with the ESM and eventually, modest shared resolution funds, support it.

The other components of banking union, however, support national responsibility for keeping banks in order and dealing with the consequences when banks fail or are close to failing. In the medium to long term, the existence of the ESM is sufficient to ultimately keep financial stability together when national deposit insurance, resolution funds and public backstops fail, but primarily in ways that continue to put pressure on the weakest links of the European banking system.

What happens from this conflict remains to be seen. The member states may choose to accept that the ECB has carved out new areas of responsibility, or it may choose to provide a more credible alternative to the ECB's provision of LLR facilities. This would have to be through the ESM. Indeed, the standoff between Greece and the euro zone in mid-to-late June 2015 revolved partly on transforming the ESM into a much more important and robust lender. The ESM, in Greek plans, would have made funds available to restructure Greek debt and relieve the pressure of financial markets on the Greek state and banking system, which in turn would have reduced the dependence of the Greek banking sector on ELA. This went against German, Dutch and Finnish plans for the ESM to be used only in the utmost of emergencies, if ever, however. Given the ECB's secure legal position in providing emergency aid, however, the extended crisis situation of the euro zone, and the opposition of Germany and its allies to transforming the ESM into a reliable public backstop, it is conceivable that the ESM might be transformed so that the member states claw back emergency powers the ECB has accrued.

### **Acknowledgements**

The author gratefully acknowledges helpful comments by Rachel Epstein, Martin Rhodes, Huw Macartney, Randall Germain, Mark Cassell and Zdenek Kudrna.

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