

***The European Central Bank as a Policy Entrepreneur within Banking Union***<sup>1</sup>

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**1 BANKING UNION AND THE CHALLENGE OF FINANCIAL STABILITY**

The European Union, together with the euro zone, negotiated a set of new policies and institutions on banking union from 2012 onward to enhance financial stability and resilience within the European economy. These policies and institutions comprise the Single Supervisory Mechanism, the Single Resolution Mechanism, a European Deposit Insurance System, and a European public backstop mechanism. These individual items represent parts of a financial stability architecture that Europe needs to combat crises and prevent contagion before, during and after the onset of a crisis. Supervision focuses on crisis prevention through the application of prudential standards. Resolution and deposit insurance systems help to prevent a bank's collapse from initiating contagion: inflicting fatal damage on other banks, or instigating panic. Finally, public backstops provide a lender of last resort function to the banking sector as a whole when all else fails.

Most policy analysts saw the euro zone crisis, which amplified Europe's banking crisis, as an opportunity to change that architecture so that it would be fit for purpose in an integrated European capital market. A single market with banks doing business across national borders would necessitate a supranational architecture of European supervision, resolution authorities, insurance funds and public backstops that together could provide robust regulation and emergency response measures. If such a move were taken, banks could respond to the continent's economic downturn by merging, restructuring and doing more business across national borders (Véron 2012). In the absence of a new architecture, Europe could only choose between economic and political fragmentation as banks retreated behind the relative safety of national borders, supervisors and state guarantees, or chronic and persistent financial instability typified by a mis-match between the European scope of banking and national responsibility for financial stability (Donnelly 2011).

What is remarkable about that policy analysis is the high degree of consensus about the functional complementarity of the institutional reforms being sought, as well as the necessity of ensuring that institutions and banking activity were present at the same level. Functional complementarity means that the institutions rely on one another to function properly, so that if one of them is missing,

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disabled or dysfunctional, that it undermines the ability of the other institutions to do their jobs properly. Specifically, supervision works only to the extent that there is a contingency plan if a bank must be closed. It therefore requires a functioning resolution and deposit insurance system. These systems, in turn, can only prevent systemic collapse if there is a public backstop that steps in when special funds for resolution and deposit insurance have been exhausted (De Grauwe 2012). It follows that the EU's financial stability architecture should be supranational, at the EU level, in order to provide financial stability for an integrated European capital market.

To date, the EU's progress on supplying the institutions of banking union have been patchy and incomplete, despite some significant achievements. The Single Supervisory Mechanism has moved European bank supervision farthest toward EU-level competence of all the banking union innovations. The ECB directly oversees 128 of the EU's 6000-plus banks, and has powers to influence how national supervisors do their jobs, but the jury is out on how strong a grip the ECB will have on them. The Single Resolution Mechanism, in contrast, lacks the independent authority to wind down a bank, restructure it or otherwise act as a resolution authority is expected to. Instead, it attempts to harmonize the approach that national authorities take when confronted with an insolvent bank, and makes recommendations to the European Council if the bank is large enough to be directly supervised by the ECB. Negotiations on a European Deposit Insurance Scheme, in contrast, have gone nowhere. Similarly, negotiations over a public backstop generated the European Stability Mechanism, which fell far short of the functional requirements of staving off systemic collapse.

Two views prevail on whether this is the end of the story, or whether banking union will evolve to develop stronger supranational competences over time. Functionalist analysts expect more institutions and competences to develop over time; students of power politics expect that the end of the line has effectively been reached, in which national governments will block further progress toward supranational institutions.

Functionalists point to two developments in support of their claim: that despite the initial resistance of many EU governments to relinquish the ties they have to their own banks, that many, particularly those in the distressed states of southern Europe, saw the benefit of collective action quickly and lined up to support supranational regulatory power and financial resources in the banking sector (Spendzharova 2014). In turn, they saw that Germany, the principal opponent of such supranationalism, gradually dropped some of its objections on supervision, resolution and cross-border financial assistance in order to ensure a bare minimum of financial stability in the EU. The second development is that the ECB successfully built out its own claim to supervisory authority from 25 to 120 banks, which might imply that it will be able in the future to claim additional supranational powers that Germany had not intended to delegate.

Students of power politics point to the massive gap between the demands that functionalists made for a European financial stability architecture and the apparent unwillingness of European governments to transfer those tasks to the EU (Donnelly 2013, Helleiner 2014). This could be seen in the ubiquitous presence of national authorities in all institutions and mechanisms related to banking union, as well as in the national dominance and control of financial resources, particularly in public backstops. They also point to the manner in which southern Europe and Ireland in particular found themselves at the losing end of a power play to distribute the costs and benefits of financial stability

in Europe. Those countries found themselves trapped between speculative financial markets that would flee any country in which they had lost confidence, and a trio of states—Germany, the Netherlands and Finland—intent on demanding international treaty obligations and constitutional amendments from other states that forced their EU neighbours to pay for resolution and deposit insurance themselves, and to balance their budgets in perpetuity, limiting their ability to provide a public backstop. Rather than a European banking union with fully functioning EU institutions, Europe came out of the negotiation process for the most part with a fragmented collection of national banking systems supported by national authorities, some of which would lack the financial resources to guarantee its safety of any sizeable banking sector.

This paper takes the position that on balance, the students of power politics can explain more of what has happened, and that the implications must be made apparent, so that banking and financial stability continue to operate sufficiently at the same level. The reality of national responsibility for financial stability means that most EU countries, including non-euro zone countries, and southern European countries in the euro zone in particular, have very strong incentives to shrink and deleverage their banking sectors until such time as the economy in general and public finances have grown to support it properly as a lender of last resort. There are only two ways to achieve this fiscal capacity relative to banking activity, however. One possibility is that the peripheral economies of southern and eastern Europe will have to divert resources from consumption into export production and generate significant current account surpluses that in turn allow public budget surpluses without suppressing economic activity. To the extent that an export-led diversion of resources is not possible, however, it means that a massive internal devaluation of more than 30%, with an attendant contraction of domestic banking (Tilford, 2014). This would also do the trick, at the cost of domestic banks disappearing from the market, to be replaced (likely) by foreign competitors (Epstein 2008). Financial stability would then be more complex, being tied more strongly to foreign conditions (Epstein 2013).

This paper also cautions, however, that the trajectory taken is probably unsustainable, given the massive costs that it imposes on most EU governments, and given the EU's poor track record to date on forcing such adjustments on national governments and electorates. This track record, and the implications it has for financial stability, harbours a new round of the euro zone crisis in the medium term as sources of bank and sovereign insolvency continue to reinforce one another (De Grauwe 2013).

The rest of this article proceeds as follows. Sections 2 and 3 briefly examine the functional requirements for supervision, and resolution and deposit insurance respectively, and outline the existing institutional features. It also outlines why the EU has not been able to agree on deposit insurance. Section 4 briefly outlines the arguments for public backstops and what they would look like at the European level, and contrasts them with the provisions of the European Stability Mechanism and of the Treaty on Stability, Coordination and Governance (TSCG), which deal with collective capacity and individual state capacity respectively. Section 5 concludes.

## 2 BANK SUPERVISION AND REGULATION

Bank supervision applies regulatory rules and principles in such a way that serious threats to the liquidity and solvency of banks are known, so that they can be dealt with to the extent that they cannot be avoided through prudent behaviour in the first place. A supervisor may be involved in the establishment of rules, particularly to the degree that legislation gives it significant leeway in interpreting and applying regulatory principles. Supervision covers a number of tasks: prudential standards on corporate governance (how the bank is organized and steered), financial reporting (timeliness, comprehensiveness, accuracy, transparency) and capital adequacy (leverage and equity ratios, asset quality and risk weighting). Ensuring capital adequacy is focused on here as the most important task at hand in the European scenario.

Capital adequacy standards are designed to ensure that banks have enough capital on hand to meet their regular repayment obligations and to compensate for any decline in income or asset value. The supervisor is therefore responsible for ensuring that it has an accurate picture of the bank's assets and liabilities, that banks hold a certain percentage of their capital in cash or extremely safe securities, and that they set aside more cash as they invest in riskier and riskier assets. Global standards on capital adequacy (Basel III), modified by the EU (Capital Requirements Directive IV and Capital Requirements Regulation) constitute the static benchmarks that banks must meet and that the supervisor must test.

The supervisor's assessments also need to be forward-looking and reflect possible negative trends. This is all the more important in a market where the economy is weak and fragile, where the risk of a major credit event (such as the bankruptcy of a major bank or national government) is medium to high, and where stocks, bonds, derivatives and other asset prices are subject to significant downswings. The supervisor needs to do this via a stress test, which establishes a hypothetical scenario and models whether the bank would survive the downturn or credit event.

In this context, supervisors have found themselves torn between wanting to bring the banks back to health quickly by exposing weaknesses that force corrective action, and instilling confidence in financial markets that the adjustments demanded are manageable and incremental in nature. This can mean fudging the results to paint a slightly better picture of the bank's balances than might otherwise be indicated. In the European Union, the European Banking Authority, which gained the responsibility for stress testing before the establishment of the ECB as the single supervisor, and held onto that role in the SSM, has shown little independent will to apply stress testing rigorously. The result is that the EBA demonstrated limited capacity to restrict forbearance by national supervisors, in which supervisors deliberately overlooked toxic assets and insufficient capital buffers. The consequence in more than one case was the failure of supervision to generate an early warning of problems, or to force corrective action. The EBA's internal political obstacles were also shown in its choice of scenarios that would be included in stress tests. At the time when the European Council negotiated a restructuring of Greek sovereign debt, for example, the EBA refused to include such a scenario in its 2011 stress tests. Nor was the EBA able to intervene or impose consequences when German banks pulled out of stress testing the following year, with the approval and protection of their national supervisor. All of these outcomes were reasons to take stress testing away from the EBA—an intergovernmental body—and place it with the ECB, a supranational one, but the member

states would not agree to it. The ECB's will not be able to supervise properly without ensuring stress testing quality.

However, the ECB has not disappointed those who expected it to pursue innovative measures to counter national protectionism, foot dragging and forbearance. Alongside the EBA's stress tests, the ECB decided to conduct its own review of the assets on bank balance sheets in advance of the stress tests, in an exercise known as the Asset Quality Review, or AQR. The idea was that the AQR would expose at least the assets on bank balance sheets to scrutiny, so that that part of the equation could not be hidden, downgraded or ignored in the stress test that would follow. The principal challenge the ECB encountered was the lack of staff to do this job independently. In response, it turned to an independent company to assist it. However, that company had been involved in stress testing before that had not fared better. It therefore remains to be seen whether the AQR exercise will be successful in ensuring a fair and rigorous stress test by the national supervisors acting in concert within the EBA.

The stress tests themselves will rely in part on the accuracy of the information on asset quality, the risks associated with them, and on leverage. They will also rely on the rigour with which the stress scenarios are conducted and carried out. This means not only the assumption of what macroeconomic or credit events might confront European banks, but also what options would be available to banks to protect their solvency under deteriorating market conditions. Open questions about the methodologies used by the private contractor in the AQR have already been raised—with particular reference to the capacity of banks to sell some assets—particularly derivatives—for cash during a downturn. As the 2008 crisis showed, it is unwise to assume that such instruments are liquid during a crisis.

Nevertheless, stress tests do have some effect, which is that it puts pressure on banks to raise capital (equity) they might otherwise not. To date, stress testing has in effect been handled by national supervisors. This had the following effects: (1) the shedding of foreign exposures, which the supervisor deemed as riskier, whereby the banking market in Europe became increasingly renationalized, and (2) increased equity – in which banks sell additional shares on the stock market and hold the cash as a strategic reserve. However, these equity-raising exercises appear to never be enough, turning into an annual exercise since the onset of the crisis. This raises the question of whether (3) national supervisors were exercising forbearance on the worst of the banks' problems, and whether (4) zombie banks would persist as a result. Will the EBA's stress tests have the same effect as its previous exercises, or will the AQR ensure that more pressure is applied to be more rigorous, as the ECB would like to see? Only time will tell, but the ECB's decisive action is a key step in the right direction, on its own initiative.

Overall, supervision has taken a step change toward greater strength, independence and rigour under the establishment of the SSM. It is by far the greatest success of banking union so far. It is also the element of banking union that had the strongest German support, since Germany insisted on rigorous supervision of banks if it were also to support the establishment of the European Stability Mechanism as an emergency fund for bailing out failing banks in the euro zone.

### 3 BANK RESOLUTION

Unlike supervision, Europe has found it far more difficult to agree on resolution and deposit insurance authorities, and the funds that go with them to make the job of those authorities possible. Bank resolution takes place when a bank can no longer survive without assistance, and where a decision has been made to wind it down in a controlled fashion rather than prop it up with public money or risk an uncontrolled collapse that ripples throughout the financial system. The capacity to do so is therefore considered an essential part of tackling the too big to fail (TBTF) problem that confronted public authorities worldwide at the onset of the crisis, and in breaking the negative feedback loop between banks and sovereigns within the euro zone.

Resolution takes place by any combination of four mechanisms: asset separation transfer, asset transfer and bail-ins, in addition to liquidity injections. These tools must be used decisively and quickly in the event of an impending bankruptcy by a resolution authority empowered to intervene in the rights of shareholders, bondholders, and depositors, and with access to sufficient funds to ensure that no other parties are so severely damaged that they collapse themselves as a result of the changes. Asset separation refers to removing toxic assets from a bank's balance sheet and transferring them to a special purpose vehicle, typically a state-run institution known as a bad bank. Asset transfer refers to the sale of (valuable) assets to other banks in the event that the original bank is allowed to die and the useful assets are being harvested, or to a newly-created counterpart to the bad bank, known as a good bank. A variation of this is wholesale transfer of ownership, in which the ailing bank is sold to a competitor, which then carries on the business. Bail-ins force bondholders and unsecured creditors to whom the bank owes money to accept partial or even total losses on the value of their investments. Doing so reduces the bank's liabilities. After a certain bail-in threshold, however, those losses will trigger collapses of other banks that hold those bonds. When this threshold is reached, capital injections need to be used to counter any shortfall that would otherwise create a systemic crisis. To avoid moral hazard by banks, who might otherwise rely on taxpayers to fund them in a crisis, and to increase the availability of funds to fulfil this purpose, the first line of capital injections needs to come from a resolution fund that banks themselves pay for, and pay into in advance of a crisis (ex ante funding). The size must be sufficient to intervene in the collapse of one or a few banks that the resolution authority can use at its discretion. Behind this, there must be a public backstop (discussed below) when the resolution fund is depleted.

The first stage of the economic crisis involved a significant effort by national governments, with the approval of the European Commission, to prop up failing banks with various forms of state aid and direct measures, ranging from capital injections and public guarantees on the assets on bank balance sheets to direct public ownership. During the euro zone crisis that followed, resolution became a more frequent occurrence as the problems that banks and governments faced both worsened. Assets and income flows became worth increasingly less for banks as the economy deteriorated and the first debt restructurings in Greece took place. Governments, meanwhile found their fiscal positions dramatically worsened by rising expenditure, declining tax revenue, and for southern Europe in particular, rising interest rates that had to be paid to bond markets in exchange for investing in treasury bills. This combination of circumstances meant that national authorities engaged in resolving national banks increasingly from 2011 onward. This underlined the ECB's 2012 demands that if the EU's single market in capital should not be torn apart, that a European resolution

authority with sufficient capital to prevent a bank's closure from undermining other banks would have to be agreed.

In the negotiations that followed for a single resolution mechanism, the member states of the EU found themselves at odds with the ECB, Commission and Parliament over two issues: resolution authority, and a resolution fund. Whereas the European institutions promoted an EU-level authority with the power to undertake all decisions and actions independently, the Council insisted on the primacy of national authorities, with an added EU layer to deal with the 128 banks being supervised directly by the ECB, dominated again by the member states. The Single Resolution Board was established as an advisory body to the European Commission regarding the resolution of euro zone banks, and as a forum for coordinating the efforts of national resolution supervisors when dealing with a bank that is significantly represented in more than one member state. The Commission decides on the advice of the Board whether to initiate resolution proceedings, which first must secure the approval of the Council. In terms of decision making, the SRM is far more of an intergovernmental body than a supranational one, given its structure and capacity to act quickly.

The Bank Recovery and Resolution Directive also agreed to the erection of a resolution fund, into which banks themselves would pay, reflecting expectations from the banking supervision community that such funds were required to carry out a resolution without threatening to undermine the stability of the financial system as a whole. However, there were four problems with the fund that undermine its capacity to play that role. The first element is size. Whereas comparable banking systems indicated that the SRM would need more than 300 billion euros in funds, the member states agreed to 55 billion. The second is the long transition period before the national contributions agreed would be paid up—to 2026. The third element is the creation of national compartments. Monies paid into the fund over time could only be used in the resolution of banks from the same country until future provisions for mutualisation take effect. The fourth is the political difficulty with which the monies could be released. Rather than leading to legal and political certainty of the EU level to act, and the financial capacity to do so, the SRM still effectively ensures that national resolution authorities and funds are responsible for dealing with bank collapses (Howarth and Quaglia 2014). This again raises the prospect, together with national responsibility for supervision in most cases, of forbearance, zombie banks and the continuing balkanization and Japanization of the European economy, resulting in a fragmented capital market and a stagnant economy. This effect is likely to be strongest in those countries of the euro zone where economic decline has been the strongest, the challenges to bank viability are therefore strongest, and where the capacity of government to provide public backstops is the weakest. That component is discussed next.

#### **4 PUBLIC BACKSTOPS**

Resolution and deposit insurance funds are meant for single banks in difficulty. They cannot hold up to systemic crises. For that reason, a public backstop serving as a lender of last resort, particularly where the central bank is unable to do so, is deemed necessary for financial stability. The impact of the euro zone crisis, which undermined the capacity of some national governments to provide that kind of public backstop, was strongest in those countries where financial markets most strongly doubted the capacity of the national government to repay what they had borrowed. The larger the

banking sector and the riskier the investment profile, the stronger the need for a public backstop that exceeds the capacity of resolution funds and deposit guarantee systems to handle.

In this context, two European initiatives, both spearheaded by the German government with the support of the Netherlands and Finland, provided for emergency support on the one hand, but in general, further restricted the capacity of national government to provide a public backstop. Those two initiatives were the Treaty on Stability, Coordination and Governance (TSCG) and the European Stability Mechanism (ESM). Both treaties were negotiated, agreed and tabled for ratification simultaneously, with a clause insisting that only signatories of the TSCG would be eligible for financial assistance through the ESM. The TSCG, now signed by all EU member states save the UK, Croatia and the Czech Republic, commits governments to balance their budgets in perpetuity, and to build down their debt levels. This severely limits the capacity of national governments to fulfil the lender of last resort function, regardless of escape clauses in the treaty allowing extra borrowing in time of crisis.

The ESM provides financial assistance to countries that have exhausted their capacity to borrow on private capital markets, but in ways that increase the strain on the broader European banking sector as a result of the terms and conditions it attaches to disbursing aid. In the public sector, governments must engage in budget retrenchment, structural reforms and internal devaluation in return for the release of financial assistance from the ESM. In the private sector, which means for the purpose of funding insolvent banks, the terms and conditions of financial assistance include a cap of 60 billion euros for the entire euro zone, meaning heavy reliance on bank closures, resolutions and the extensive use of bail-ins for investors and uninsured depositors. Many of those investors are other banks that then may experience difficulties of their own, and whose public authorities may or may not have the capacity to support them if the strain becomes too great. The scenario of such a domino effect loomed briefly during the resolution of Laiki Bank in Cyprus in 2013, when the head of the euro group stated that depositors would also lose their insured savings, opening up prospects that depositors across southern Europe would flee to safer havens in the north (Salmon 2013). Although the German finance minister ensured quickly that depositors and market knew that the ESM would not attach such destabilizing conditions to the provision of aid through the ESM, he also underlined that the ESM was designed for emergencies only, and not designed to significantly enhance the deployment of public backstops. Those capacities remain at the national level, and unevenly distributed, with the consequence that the EU's financially weaker governments will remain sources of enhanced instability risk. Although the Single Resolution Fund can borrow limited amounts on financial markets, a systemic event is likely to require direct liquidity creation by the ECB (Chang and Leblond 2014, Leblond 2014).

## **5 CONCLUSIONS AND POLICY IMPLICATIONS**

The first attempt to create the supranational institutions of a banking union met with some success, but far less than would be required to ensure the institutional complementarity required to supply financial stability at the European level. Much in the same way that EMU was established with a European institution in monetary policy but national authority in fiscal policy, banking union was established with the ECB as the lead banking supervisor, but national responsibility for supervising most banks, setting how high the regulatory bar would be set, and undertaking the politically



sensitive stress tests that one would expect a supervisor to do. Where European institutions were involved in these functions, it was the EBA that handled them, the body that itself admitted paralysis at the hand of protectionist national authorities and whose inability to act led to the ECB's appointment as supervisor in the first place. Resolution systems were coordinated rather than Europeanised, plans for European deposit insurance schemes failed to bear fruit, and the provision of a public backstop was all but prevented. Rather than a European architecture that provides for financial stability at the European level, the European institutions that were established largely provided for supervision, resolution and public backstops at the national level.

Nevertheless, European institutions have been established, and it remains to be seen whether the restrictions placed on the ECB and the Resolution Board will restrain them from further growth. The capacity of the ECB to advance its own agenda and powers under significant opposition in both the management of EMU and in its role as bank supervisor, even if not to the extent it would like, suggests that it will step in in innovative ways where required. This can be expected not only in the realm of supervision, where the ECB will have the incentive to be tough in reviewing asset quality, but also in the realm of stress testing, which officially remains the EBA's responsibility, and in the realm of coordinating and directing national supervisors. The institutional blockages in resolution are stronger, but the ECB can choose to act aggressively in ways that forces the Board, and thereby the Council, to react.

The primary reason why there may be limits on the ECB's capacity to forge forward in these ways is that it lacks control of a highly intergovernmental resolution process, and a situation in which resolution funds, capital injections and public backstops may be undersupplied. In those situations, the ECB's role as supervisor will clash with its mission to underpin financial stability, placing it in a difficult position.

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