

Diversity of the EU banking sector: what ways forward?

The diversity of the European banking sector is widely recognised as a key strength, supporting financial stability, resilience and the financing of the economy. At the same time, it raises important questions about how the regulatory and supervisory framework can ensure consistent standards while reflecting the wide range of business models across the EU.

There is broad consensus on the importance of a harmonised single rulebook and the principle of proportionality. However, translating these principles into practice remains a key challenge, particularly in the context of increasing regulatory complexity and evolving supervisory expectations.

Against this backdrop, discussions focused on how to better balance harmonisation and diversity, enhance risk-based supervision, and adapt the framework to broader objectives such as competitiveness, strategic autonomy and the financing of the European economy.

1. Preserving diversity in a harmonised European banking framework

1.1 European banking diversity

The Chair stated that diversity is an established characteristic and fundamental strength of the EU banking landscape, as evidenced by its varied business models, footprints, activities and strategies. It facilitates the allocation of funding to the areas of the EU economy that need it most, and mitigates the risks associated with herd behaviour and systemic contagion, thereby enhancing the sector's resilience to economic shocks. The objective is to preserve, foster or enrich this diversity, which leads to consideration of the appropriate prudential treatment, the balance between harmonisation and proportionality and whether these concepts are in tension. Participants also highlighted the potential impact of regulatory design and proportionality on consolidation trends within the banking sector.

1.2 Embracing harmonisation while preserving diversity

1.2.1 A single rulebook

A Central Bank official observed that a key objective of the banking union and the single rulebook is to ensure meaningful oversight of all banks in the eurozone, whether they are global systemically important (G-SIBs) institutions or local, cooperative or mutual banks. The harmonised single rulebook ensures a uniform level of supervisory rigour and prevents regulatory arbitrage

arising from divergent national regulations and thresholds based on size. Proportionality is integral to this framework, as stipulated by the Capital Requirements Directive (CRD).

1.2.2 Common rules and joint supervision

A Central Bank official commented that current applications of proportionality include distinctions between SIs and less significant institutions (LSIs), with, for banks supervised directly by the ECB, varying levels of Joint Supervisory Team (JST) engagement based on size and complexity .

In addition, the regime for small and non-complex credit institutions (SNCIs), with assets totalling less than €5 billion, features simplified reporting requirements. SNCI institutions currently report approximately 30% of the data required under the full financial reporting framework (FINREP).

Efforts have also been made to refine the Supervisory Review and Evaluation Process (SREP), which has been improved by prioritising key risks and adopting a more risk-based approach. Further improvements are planned for the coming year.

Business model sensitivity is also considered through questions on how clusters and peer groups are used, which facilitates comparative assessment without demanding uniformity, since not every entity will be in the same group. This allows for a better balance in the risk-based approach taken by supervisors.

Nonetheless, the current framework can still be improved. The Governing Council's High-Level Task Force has recommended expanding the degree of proportionality in the EU under the existing SNCI regime in a prudent manner. Efforts are also being made to reduce and harmonise the applicable requirements across member states, to minimise the patchwork of national implementations and avoid fragmentation.

In parallel, the ECB's Supervisory Board has overseen a project aiming to simplify the supervisory approach by asking simpler questions and focusing on specific risks rather than all risks over multi-year cycles when this is less relevant. The goal is to respect diversity in the banking sector while maintaining consistent risk policies and risk appetites across all institutions.

1.3 Opening the market to innovative solutions

An official emphasised that when discussing proportionality from a supervisory perspective, insufficient focus appears to be given to market openness and the emergence of new entrants, such as neo-banks. Prioritising support for Schumpeterian creative disruption in discussions with supervisors is crucial.

2. Limits of the current EU framework

2.1 EU banking regulation

2.1.1 *The increasingly complex rulebook*

An industry representative observed that, to date, regulatory reforms have possessed merit. They increased the own fund capital and liquidity requirements for European banks, which is positive for financial stability. However, the regulatory framework in the financial sector has grown an unprecedented amount, both in scope and complexity, creating risks for institutions of all sizes. The multi-layered structure of legislation poses compliance challenges for both authorities and banks. Independent regional banks are extremely important for local economies, and the complexity disproportionately affects regional banks. It hinders their ability to comply with all requirements, which contributes to the decline in their numbers.

2.1.2 *Towards a more risk-sensitive and proportionate framework*

An industry representative stated that nobody wants deregulation. The aim is to make it easier for the financial sector to comply with the requirements. A comprehensive financial omnibus act is needed at Level 1 to address this issue. However, reliance on omnibus legislation alone was seen as potentially risky, given uncertainty regarding its scope and content. The current one-size-fits-all approach is neither risk-sensitive nor proportionate, and it increases complexity. Past relief measures, such as those for SNCIs under the Capital Requirements Regulation (CRR), focused solely on reporting and disclosure requirements, which was insufficient. A more substantial, risk-oriented act is needed to stimulate financing and investment in Europe.

Consideration should be given to aligning the implementation of the Basel framework with the approaches adopted by other jurisdictions that offer special regimes for small and regional banks. The EU should carefully consider which banks to implement the Basel Act for, and where future relief could be granted. Currently, Europe applies the entire Basel framework to all types of banks and should consider how to simplify compliance for smaller institutions.

2.2 Beyond incremental proportionality

2.2.1 *Limits of incremental proportionality*

A regulator outlined that Germany is home to around 1,300 banks, accounting for around two-thirds of all Eurozone banking institutions. Many of these banks are very small. A pure one-size-fits-all approach would produce unintuitive results for such a range of banks. European institutions recognise the need for risk-based supervisory practices that are tailored to the characteristics of individual institutions, including their size and complexity, as well as the risks they pose to the overall system.

A tiered system is already in place, comprising an intensive Tier 1 supervision dedicated to SIs, where JSTs and numerous people from various institutions examine the banks. Tier 2 comprises the LSIs, and it could be argued

that there is already tiering within the LSIs. Attempts are being made to reduce the requirements for small banks.

Incrementally progressing means proportionality and risk-based supervision will take time. Germany's implementation of the EBA guidelines involves applying proportionality wherever possible. BaFin has introduced new subsets of banks to specify its expectations on certain topics. A new version is being published that deliberately excludes significant institutions, due to the more complex supervision they require.

2.2.2 *Designing a simplified regime for smaller banks*

A regulator suggested there should be more than just incremental changes. The European environment is very complex and needs to be more efficient. Germany has proposed a rough design for a regulatory regime specifically tailored to smaller banks. This regime would entail higher capital requirements in exchange for simplified operational and reporting obligations, in an attempt to avoid criticism about the loss of a level playing field. However, if the requirements are much simpler and many supervisory elements are removed, high capital charges will be necessary. A separate regime has many virtues and can be implemented without compromising capital or the system's overall safety.

An industry representative commented that banking supervision operates within established political commitments geared towards growth and strength for all enterprises and the broader economy. Supervisory practices present significant compliance challenges for smaller banks. There is no appetite to provide relief for weaker banks.

The Chair underscored the importance of understanding the trade-offs inherent in simplification efforts, to avoid mistakes observed in other jurisdictions.

2.3 Proportionality and resilience

2.3.1 *Enhancing risk sensitivity*

A Central Bank official stated that resilience is a prerequisite for proportionality, and not an alternative. The European prudential framework has consistently demonstrated its robustness in the face of recent pressures. The focus should be on enhancing risk sensitivity and operational effectiveness, rather than relaxing existing regulations. The regulatory and reporting landscape is very complex, and overly formalistic processes are not properly aligned with institutions' actual risk profiles. A one-size-fits-all approach creates unnecessary compliance costs and diverts management attention away from material risks. The current approach risks creating too many institutions that are too small to comply, which could paradoxically reinforce market concentration and the "too-big-to-fail" dynamic instead of mitigating it.

The revised SREP framework introduces a risk tolerance framework with a multi-year approach. This is designed to direct supervisory efforts towards the most significant risks and the specific risk profile of each institution. The SREP reform also incorporates a new, tiered follow-up process for findings, and more focused SREP letters that clearly highlight priorities and key risk drivers. These changes, coupled with enhanced risk-based methodologies

and reduced data requirements, are intended to free up resources for allocation to the most critical areas. The intention is to align legal principles with a risk-calibrated supervisory approach. The SSM is pursuing this objective within a coherent framework by improving risk sensitivity without excessively fragmenting supervision.

2.3.2 Anchoring proportionality in resilience

A Central Bank official emphasised that proportionality has limits. Size alone cannot be equated with risk. Small banks may pursue niche business models or engage in activities that are inherently risky and present significant vulnerabilities, thereby meriting a more intrusive approach. Furthermore, the increasing digitalisation of business models introduces operational complexities that could narrow the scope for lighter regulatory regimes. Therefore, any simplification measures must be accompanied by robust structural safeguards, including solid capital buffers, strong governance structures, and adherence to appropriate standards. This will allow supervisory relief to be reversed if risks escalate. Institutional diversity is a means to an end. It supports financial stability and sustainable economic growth. Supervisors should strive to remove unnecessary friction while preserving the resilience built up over the past decade.

The Chair highlighted the significant impact of the approach to supervisory judgment. A crucial aspect is discerning whether differences in application stem from objective risk-related factors or other considerations and evaluating the impact of potentially diverging practices on the integrity of the single market.

2.4 Embedding risk-based proportionality in banking supervision

2.4.1 True risk-based approaches

An industry representative observed that, despite the consensus on respecting diversity, the merits of a single rulebook and not wanting to deregulate, there are significant differences in terms of implementation and operationalisation. The tendency to adopt a one-size-fits-all approach persists, despite acknowledged efforts to streamline processes. In reality, supervisory practices often rely on established benchmarks for best practice and fail to adequately accommodate the diversity of business models. Low-risk banking models are often not considered sufficiently. Banks encounter difficulties in demonstrating their low-risk profile within the existing framework.

2.4.2 Towards a cultural shift in banking supervision to support competitiveness

An industry representative commented that the Commission's simplification process marks a turning point. The ability of all banks, particularly savings banks, to provide financing is at stake. Attention should be paid not only to the regulation itself, but also to supervisory practices. Banks should consider the secondary mandate, which takes competitiveness and stability into account alongside financial stability. If that is not possible, a 'financing the economy test' could be conducted for each new regulation or amendment to delegated acts, to assess the impact on banks' capacity to provide financing.

However, impact assessments are not consistently considered. A fundamental cultural shift within banking supervision is needed. Rather than categorising banks based on their institution type, those with inherently low-risk models or specific governance structures should be recognised accordingly.

3. A more efficient, risk-based and strategic European banking framework

3.1 Evolving banking supervision

An industry representative stated that the ECB and SSM have demonstrably improved the quality of the European banking sector over the past decade. As the banking sector matures, new expectations emerge regarding how supervision should evolve. As well as differentiating between large and small banks, it is also important to distinguish between strong and weak institutions. A robust culture within an institution is vital for preventing failure and safeguarding the funds of European depositors. Strong banks will have strong SREP scores and ratios. SREP should consider how well-developed and established a bank's culture is, as this is relevant to the likelihood of a bank failing and to depositor confidence.

Supervision should pay closer attention to banks with weaker fundamentals. The aim is not to reduce supervision, but to make it smarter, which includes banks having fewer supervisory meetings. A risk-based, proportionate and outcome-focused supervisory approach should be embedded in practice. The administrative burden on well-performing institutions should be reduced without compromising prudential standards. Supervision intensity should be aligned with institutional strength, involve fewer meetings and inspections, and have fewer ad hoc requests for consistently robust banks.

The ECB's drive for internal efficiency should not result in an increase in on-site visits or meetings for banks with strong fundamentals. Supervision should focus on what is important for banks rather than on how they operate. Progress has been made by making the SREP more risk-based, but the impact remains limited at the operational level. Supervisors should focus on elements that directly impact financial stability. Today's supervisory framework is still too prudent, detailed and intrusive.

The Chair emphasised that proportionality should not subsidise loss-making business models, and attention has to be paid to how good behaviour from banks is rewarded. Before the SSM, supervisory practice involved starting meetings by recognising the bank's achievements before addressing the areas that need improvement. Dialogue should acknowledge the positives alongside identifying deficiencies.

3.2 Smarter supervision in a digital age

An industry representative highlighted the potentially transformative impact of AI on the banking landscape, particularly given the risk of a winner-takes-all dynamic caused by digitalisation. The growing dependence on apps

and generative AI for financial advice could cause clients to turn to unregulated alternatives, which is a significant change that regulators may be overlooking in discussions about open finance. EU employees are increasingly being trained to use, and encouraged to utilise, AI tools. The way customers approach financial services will change. These factors should be considered when addressing competitiveness issues as part of the Commission's consultation process.

3.3 Addressing US dominance in wholesale banking

An industry representative asserted that there are no impediments to new entrants within the EU's banking sector, given the significant growth of digital banks and newcomers. However, the substantial dominance of US-based banks, which exceeds 50% in the wholesale market, is a critical issue and a unique problem for sovereignty among international jurisdictions.

3.4 Simplification, competitiveness and unlocking capital for the economy

3.4.1 Streamlining the regulatory framework

An official noted the significant momentum surrounding these topics. The Commission is holding ongoing consultations, and the European Council reached conclusions the previous week. The banking agenda should be considered in the context of broader political objectives, such as strategic autonomy.

Simplification is part of a broader process underway within the Commission, but institutions like the EBA, ECB and the SSM can do more. Rather than relying solely on omnibus legislation, a more comprehensive approach should be adopted, given the uncertainty regarding its scope and content.

Serious efforts should be made to transform directives into regulations to avoid gold-plating and divergent implementations. Additionally, a thorough review of empowerment levels within Level 2 and Level 3 measures should be conducted to reduce the overall complexity of the rulebook.

Proportionality should be applied consistently to significant institutions and smaller banks alike. It is also beneficial to maintain a supportive framework for new companies entering the market. Aligning the Minimum Requirement for Own Funds and Eligible Liabilities (MREL) with the Total Loss-Absorbing Capacity (TLAC) requirements, particularly for larger banks, could further streamline the regulatory landscape.

3.4.2 Strengthening competitiveness and unlocking capital

An official stated that it is important to have a level playing field globally, so Europe should try to follow in the footsteps of its peers, particularly the US. Steps to neutralise the impact of trading rules on bank capital are welcome. The previous week, the Fed proposed overhauling capital requirements for US banks and releasing up to 5% of capital, which will require a response.

There is a need to mobilise private investment within Europe and to re-evaluate existing capital requirements, including the number of capital stocks and buffer layers.

Although this is a sensitive issue, it should be part of the discussion so that capital can be freed up for the benefit of the economy.

Consolidation among larger players is important, and the Commission does a great deal with regard to the rules on mergers and acquisitions. Simplification should occur as quickly as possible to enable progress on the Capital Markets Union (CMU). Some of the capital relief could be used to finance the economy. With regard to the Banking Union, the principles set out in the 2022 Eurogroup statement remain applicable. The Banking Union must be completed through consensus, taking into account regulatory treatment of sovereign exposures, the European Deposit Insurance Scheme (EDIS) and potential waivers regarding ring-fencing. The proportionality principle should apply to these areas.

4. Conclusion

The Chair argued that there is convergence on the principles and the need to reflect diversity considerations. However, considerations should extend beyond the banking sector itself and encompass factors such as economic growth, banking objectives and political considerations, particularly strategic autonomy and global competitiveness.

A key challenge lies in execution. Regulation can be refined by carefully considering the difference between rules and regulations versus directives, and their specific content. Incentives can be established to define the sizes of organisations and to reward compliant behaviour.

Impact assessment methodologies must be strengthened. In the EBA's report on strengthening the efficiency of the regulatory and supervisory framework with 21 recommendations published in October, the EBA suggests carrying out periodic reviews every three to five years. In addition, the EBA is suggesting bringing together micro/macro resolution authorities. This would provide co-legislators with information for their consideration and circumvent the complexities of implementing a competitiveness mandate through supervision or regulation. An upcoming EBA consultation on reducing reporting requirements was also highlighted, with stakeholders encouraged to contribute.

Discussions confirmed broad agreement on the importance of preserving diversity within a harmonised European banking framework, while highlighting persistent challenges in its practical implementation. Striking the right balance between harmonisation and proportionality remains central, particularly in the context of increasing regulatory complexity and continued reliance on one-size-fits-all approaches. At the same time, proportionality must remain firmly anchored in resilience through robust safeguards and genuinely risk-based supervision. Moving forward, progress will depend on both regulatory refinement and a shift in supervisory practices, alongside greater attention to competitiveness and the financing of the economy. Ultimately, the key issue is one of execution, requiring stronger incentives, more systematic impact assessments and a more evidence-based approach to policymaking.