Competitiveness and stability in banking: Two sides of the same coin

Eurofi speech, September 18, 2026

Klaas Knot[1]

Prepared remarks delivered at the 2026 Eurofi Financial Forum in Dublin

Ladies and Gentlemen,

It is a privilege to speak to you today about a topic that lies at the very heart of modern financial systems: the relationship between banking competitiveness and banking stability. These concepts are often portrayed as irreconcilable objectives or at least as subject to a real trade-off.

According to a common view, greater competition pushes banks to take more risks, thereby undermining financial stability, while stronger regulation, higher cost of capital and stability measures reduce competitiveness, hurt profits and stifle innovation. However, I would like to argue here today that this is a false dichotomy.

In reality, my sense is that banking competitiveness and banking stability are in fact two sides of the same coin, mutually reinforcing and essential for a healthy, resilient, and prosperous financial system over the medium term. In other words, the short-term gains that can be captured through deregulation are often paid via higher costs during episodes of financial instability. The point of efficiency one should seek is the one that maximizes competitiveness without increasing financial instability related costs.

This debate has recently flared up in European policy circles as well, in response to a broad deregulatory effort under way in the United States that is deemed to threaten the global level playing field and hurt the relative competitiveness of the European banking sector. Against this backdrop, the EU is undertaking a regulatory modernization drive, also inspired by the Draghi report on EU competitiveness.

The European Commission has recently issued a Communication on the competitiveness of the EU-banking sector "*to build a more integrated, efficient and competitive banking sector that can strengthen Europe's economy by financing growth, innovation, and strategic priorities, underpinned by a better-balanced regulatory framework, creating the conditions for banks to take prudent risks while safeguarding the sector's resilience, delivering better services to households and businesses, all while preserving financial stability and fostering sustainable growth*". Quite a mouthful, but I think it captures the essence and illustrates some of the complexities of the alleged trade-off.

[1] Peterson Institute for International Economics, Group of Thirty, and CFA's Systemic Risk Council. Former President of De Nederlandsche Bank and Chair of the Financial Stability Board.

Let me say upfront that I share the objective of streamlining regulation, improving supervision, and monitoring carefully developments across the Atlantic and their effect on global banking regulation. In light of what is happening in the US, I believe it is necessary to review the current prudential capital framework in the EU to address potential duplication, inconsistencies and assess whether changes are in order.

I do not want to prejudge, however, the outcome of such a review, and I do not share the anxiety that suggests the European banking system faces an existential crisis. When I look at the numbers, over the last 10 years European bank profitability has increased tremendously. A return on equity that was half of that of American banks in 2014 is now roughly equal (10.4% vs 11.6%). Price to book ratios have moved from half of the US in the last decade to more than the US today (1.66 vs 1.35). Annual dividends and buy backs that were close to non-existent in 2020 have increased to nearly EUR 120 bn today. This does not look like a highly uncompetitive banking sector to me. But I do believe there is a strong case to adapt regulation and supervision.

To zoom in on their relationship, we must first define what we mean by **competitiveness and stability** in banking.

Banking competitiveness is both an absolute and relative notion. In absolute terms, it refers to the ability of banks to compete effectively by offering high-quality services, attractive pricing, innovative products, and efficient financial intermediation. In relative terns, it refers to European banks' profitability compared to that of its main global competitors. And eventually relative and absolute competitiveness influence each other. A perfectly competitive banking market in Europe that would not be able to deliver risk adjusted returns on capital similar to that of its global peers would eventually risk being displaced.

Banking stability, on the other hand, refers to the ability of the banking system to withstand shocks, maintain public confidence, and continue performing its critical functions even during periods of economic or financial stress. A stable banking system protects depositors, supports economic growth, allows risk sharing over time and across space and reduces the likelihood of financial crises.

At first glance, one might think these goals conflict and that there is a fundamental trade-off. Yet a closer examination reveals that neither can be sustained without the other over time.

Let us begin with why competitiveness requires stability.

A fractional reserve banking system can only flourish in an environment of trust, allowing maturity transformation to take place and credit to flow. When stability is compromised, confidence evaporates. Depositors withdraw funds, lenders become cautious, investment dries up, and usually financial crises ensue, or at least economic activity slows.

In such circumstances, competition becomes meaningless because markets cease to function normally causing profound economic, political and social disruptions. Unfortunately, these risks are somewhat inherent to finance, and history provides numerous examples of their materialization.

The ones that I had to live through professionally myself were the global financial crisis of 2008 and the euro area crisis shortly thereafter. The collapse of major financial institutions triggered panic throughout global markets. Credit channels froze, economic growth contracted, and governments and central banks were forced to intervene on an unprecedented scale.

Whatever competitive benefits banks enjoyed from 'light-touch', 'self-regulation' or 'principles-based' regulation before the crisis, these were overshadowed by the enormous costs of instability afterward. Some of these institutions disappeared in the shock, others were rescued because they were deemed critical to the financial system. But all those that survived realized that a competitive banking sector requires a stable foundation.

Without sound risk-management, adequate capital buffers, effective supervision, and public confidence, competition cannot endure. The Jacques De Larosière report[2] published as early February 2009 was quite central in bringing that point home and setting out a vast movement of regulatory and supervisory overhaul in Europe. We should never lose sight of these lessons even when we review, adapt and modernize our approaches.

At the same time, stability also requires competitiveness.

A competitive banking system will be profitable and thereby have the capacity to internally generate capital. On top of this, it will likely enjoy access to capital markets, which will provide a first line of defense against unexpected losses.

At the same time, a banking system dominated by just a few institutions with little incentive to innovate or improve efficiency may appear stable on the surface, but this form of stability is often fragile and unsustainable. Lack of competition can lead to complacency, inefficiency, poor customer service, and misallocation of resources. Entry from outside the banking sector will be invited and consequent disruption might be of a more radical nature.

Competitive pressure compels banks to improve governance, adopt better technologies, and manage costs effectively. It encourages institutions to understand customer needs and develop innovative products that support economic growth. Competition also reduces concentration risk by ensuring that financial activity is distributed among multiple strong institutions rather than being concentrated in less than a handful of dominant players.

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[2] The High Level Group on Financial Supervision in the EU, Jacques De Larosière, February 2009

In this sense, competition is not a threat to stability. Properly managed, it is one of the foundations of long-term stability.

If one takes a closer look at the **EU banking sector** from this perspective, there is some reason for concern. Many national retail banking markets in the EU are characterized by what has sometimes been described as 'nice and warm oligopolies' where major competitive threats appear to have come from the tech community rather than the banking sector itself.

It is my belief that the incompleteness of the EU's Banking Union process is primarily to blame here. Many national banking markets are simply not sizable enough for larger numbers of viable competitors to generate the scale that is needed to compete at a global level, and only the EU as a whole could provide that scale.

But while in the aftermath of the euro crisis regulatory authorities have created the public institutions for a banking union like the SSM and the SRM, many banks themselves have actually retreated from cross-border credit provision in critical segments within the EU.

This is in part the result of business decisions given the scars of the shock stemming from the global financial crisis and the euro crisis. In particular, the temporary emergence of redenomination risk played an important role in the repatriation of capital and liquidity behind national borders.

But this has also been fed by national supervisory rules encouraging the maintenance of trapped pools of capital and liquidity that are still today a major factor underlying the continued fragmentation of EU banking markets. Lack of a European deposit guarantee scheme, pervasive doubts about the adequacy of the backstop, and circumvention of the single resolution framework have further impeded deposit fungibility and credit provision across member states.[3]

We are paying a price for the weakness of our banking union and this calls not only for profound supervisory changes but also changes to our resolution framework and progress to our liquidity in resolution arrangements. The CMDI package is taking meaningful steps in this direction, but it is more of a bandage rather than a structural solution.

Finally, a number of national governments have embraced cross-border consolidation in theory but have been somewhat reluctant to accept it in practice, in particular when they were on the receiving end. This is one reason for the lack of competition, especially when it is combined with consolidation within national borders. More than 10 years after the launch of the Banking Union, we are still waiting for significant cross-border banking consolidation.

[3] In response, the EU Commission recently updated its Crisis Management and Deposit Insurance Framework: https://finance.ec.europa.eu/publications/stronger-framework-handling-bank-failures_en

The key question is therefore not whether competition should exist, but what kind of competition should be encouraged. This brings us to the **vital role of regulation**.

By establishing clear rules, ensuring transparency, maintaining capital requirements, and preventing reckless behavior, regulation creates the conditions under which fair competition can thrive. Think of regulation as the rules of a sporting event. Without rules, competition becomes chaotic and dangerous. With appropriate rules, participants can compete vigorously while preserving the integrity of the game.

The same principle applies to banking. Prudential regulation ensures that banks maintain sufficient capital buffers, manage risks responsibly, and protect customers. These safeguards strengthen confidence in the financial system and enable competition to occur within sustainable boundaries.

Reflecting the global nature of many financial services, agreement on global minimum standards in prudential regulation has been key to preserve the level playing field. Since the Herstatt crisis of 1974, the Basel Committee on Banking Supervision has taken on the role of formulating globally agreed rules on the regulation and supervision of internationally active banks. Unfortunately, US banking authorities have been slow to implement the latest so-called Basel III agreement, and the 2023 mini banking crisis in the US revealed the weakness of its limited scope of application.

Moreover, in the aftermath of the global financial crisis the G20 established the Financial Stability Board for a timely assessment of financial vulnerabilities, to coordinate the work of the various standard setting bodies to address such vulnerabilities, and to monitor its implementation across the globe.

During my mandates as vice-chair and chair of the FSB, the level playing field between banks and non-banks took center stage. Under the leadership of my successor, Andrew Bailey from the Bank of England, the FSB has engaged in a process of regulatory modernization where the balance between competitiveness and stability continues to be an important theme.

In the **European context**, these developments have translated into a deregulation versus simplification debate. Let me say upfront that I welcome having this debate.

For roughly a decade and a half after the global financial crisis, financial regulators have had the wind in the sails when it came to the fulfillment of their calls for tighter rules and increased supervisory resources. It is now nothing more than healthy that after such an unprecedented surge in regulatory and supervisory intensity, we take a step back and ask ourselves the question whether all these efforts have indeed gone into the most productive directions.

I therefore understand the desire to simplify. Banking regulation and supervision has become overly complex. Over the past 15 years, a great deal of regulation has been introduced from various angles — global, EU, national. Micro and macro. Going concern and gone concern. New risks added, old ones rarely removed. Reporting requirements have swollen. And there is overlap. There is friction. And there is a lack of supervisory proportionality for smaller institutions.

Complexity and lack of coherence and coordination in regulatory requirements is not conducive to competitiveness, nor does it ultimately foster stability. It complicates integrated risk management and often triggers regulatory arbitrage into lesser regulated areas, something I have previously referred to as the waterbed effect.

But simplification is clearly not synonymous with blanket deregulation. Reducing resilience by relaxing the rules increases the likelihood of financial crises. Enhanced resilience was needed to turn our banks from shock amplifiers during the global financial crisis into shock absorbers during recent episodes of NBFI-related stress. And in our current shock-prone world of unusually high uncertainty, both on the economic and political front, this is exactly what financial stability requires.

That being said, Europe has to play close attention to what is happening in the United States and if there are aggressive steps taken by the US, the EU will face a stark choice, either restrict market access to US firms, or converge towards a similar approach to level the playing field. This might for instance lead the EU to reconsider its position on the FRTB. So, while blanket deregulation does not appear appropriate to me, targeted and limited deregulatory decisions beyond simplification might be in order.

Policymakers therefore increasingly recognize that competitiveness and stability should be viewed as complementary objectives within a broader framework of sustainable financial development. This is very much the context within which I believe the recent Communication by the EU Commission as well as earlier communications on simplification of regulation and supervision by the ECB and its SSM should be interpreted.

One can furthermore have a debate whether competitiveness should become an explicit statutory objective of financial regulators and supervisors. As I argued that healthy competition and bank competitiveness are prerequisites for financial stability over the medium term, I do not perceive an overwhelming necessity to go down that road.

Overall, my perspective is that supervisors and regulators have also an implicit primary and secondary mandate. The primary mandate is unequivocally financial stability, but I would argue that they thereby also have a secondary objective focused on competitiveness without prejudice to the primary mandate. This is similar in spirit to the hierarchy between price stability and economic growth in the ECB's monetary policy mandate. Healthy growth and a limited output gap are well understood to constitute critical prerequisites for the maintenance of price stability over the medium term, but have been subordinated to the primary mandate focusing on price stability.

Ladies and Gentlemen,

Banking competitiveness and banking stability are often discussed as though they pull in opposite directions. Yet closer examination reveals a deeper truth. Competitiveness without stability is unsustainable. Stability without competitiveness is unproductive. One generates dynamism; the other provides resilience. One drives progress; the other preserves confidence. Neither can fully succeed without the other.

Like the two sides of a coin, they are distinct yet inseparable. Remove one side, and the coin loses its identity and value. In the same way, a banking system that pursues only competition or only stability will ultimately fall short of its purpose.

The future of banking belongs not to systems that choose between competitiveness and stability, but to those that recognize their interdependence and cultivate both. By doing so, we can build financial institutions that are innovative yet prudent, dynamic yet resilient, competitive yet trustworthy.

And that is the foundation of a banking sector capable of supporting sustainable prosperity for generations of Europeans to come.

Thank you.