CEPS POLICY BRIEF

TACKLING THE TWIN PARADOX OF EU FINANCIAL REGULATION

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SUMMARY

The Lamfalussy process has generated two opposing distortions. Excessive delegation to rulemaking at Levels 2 and 3 has sparked regulatory inflation, while over-specification in Level 1 legislation has led to institutional inertia. These contradictory tendencies reflect a deeper structural issue: the absence of fully centralised supervision.

In this Policy Brief, we propose a two-phase reform strategy. In the short term, it involves streamlining existing rules and enhancing supervisory convergence. Longer term, it calls for reforming governance to empower European Supervisory Authorities within principles-based legislation, while introducing safeguards to respect the Meroni doctrine. Only by sequencing simplification and delegation can the EU shift away from legislative micromanagement towards adaptive financial governance that balances harmonisation with flexibility.

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INTRODUCTION

Over the past two decades, the EU has developed one of the most comprehensive bodies of financial regulation in the world. From the Banking Union and the Capital Markets Union to the proliferation of sectoral frameworks in insurance, investment services, payments, and sustainable finance, it has evolved into a dense, multi-layered structure. While this process has undoubtedly strengthened financial stability and investor protection, it has also generated growing concerns about regulatory complexity, rigidity, and limited adaptability.

The EU's rulemaking framework – originating in the Lamfalussy process – was conceived to combine political legitimacy, technical precision, and supervisory coherence through a tiered approach. Level 1 legislation, adopted by the European Parliament and Council, sets the high-level principles; Level 2 delegated and implementing acts provide the technical specifications; and Level 3 instruments, such as guidelines and Q&As, promote consistent application. In practice, however, this system has produced two opposite distortions.

On one side, excessive delegation to Levels 2 and 3 has resulted in a sprawling body of secondary legislation and soft law, creating what market participants describe as *regulatory inflation*. On the other, excessive concentration of detail in Level 1 has locked technical parameters into primary law, producing *legislative inertia* and slowing the EU's capacity to adapt to change. Together, these two tendencies illustrate a paradox: a regulatory system that is simultaneously too detailed and too inflexible.

These imbalances are not merely technical accidents; they stem from the institutional design of EU financial governance. In the absence of fully centralised supervision, co-legislators rely on detailed rules to restrict the discretion of national competent authorities (NCAs) and to preserve the integrity of the single market. This reliance on prescriptive legislation is both understandable and functional in the current context, yet it also perpetuates complexity and inhibits adaptation.

This Policy Brief argues that simplifying and rebalancing EU financial regulation requires a two-stage reform strategy. In the short term, the priority should be to *streamline the existing rulebook.* In the medium to long term, however, a sustainable solution depends on *governance reform*.

THE SPREAD OF LEVEL 2 AND LEVEL 3 MEASURES: REGULATORY INFLATION AND FRAGMENTATION

The EU's multi-tier regulatory framework, originally designed to balance political legitimacy and technical expertise, has over time produced a form of regulatory inflation. Legislative acts at Level 1 to the European Commission and the European Supervisory Authorities (ESAs) the task of specifying key parameters through Level 2 delegated and implementing acts and Level 3 guidelines. While this model was meant to ensure flexibility and technical accuracy, it has generated a vast and fragmented body of secondary rules and soft law.

This accumulation of mandates has progressively blurred the distinction between legislative and supervisory functions. The number and granularity of regulatory and implementing technical standards (RTS and ITS), guidelines, and Q&As have expanded far beyond what is necessary to ensure harmonisation. As a result, financial institutions face rising compliance costs and regulatory uncertainty, while supervisors confront overlapping and sometimes inconsistent obligations. For cross-border institutions operating in multiple jurisdictions, the complexity is particularly acute, undermining the very objective of the single rulebook.

A paradigmatic example is Solvency II, where the core directive delegates the calibration of capital requirements and risk modules to the Commission and the European Pensions Insurance and Occupational Pensions Authority. The outcome is a proliferation of delegated acts and guidelines specifying, in extreme detail, how each component of the solvency capital requirement should be calculated and reported. Insurers face not only a heavy administrative burden but also frequent updates to technical standards, creating a moving target for compliance.

A similar pattern can be observed in the banking sector, where the Capital Requirements Regulation (CRR) and Directive (CRD) are accompanied by an extraordinary number of RTS and ITS. These cover areas such as internal models, reporting templates (COREP/FINREP), and large exposure limits. The European Banking Authority has become, in effect, a continuous producer of quasi-legislative acts.

This trend towards excessive delegation has recently intensified with the approval of CRR III and CRD VI, which include approximately 140 new mandates for the European Banking Authority to produce more regulatory output, such as RTS, ITS, and guidelines. This represents a significant increase in the complexity of banking rules and perpetuates regulatory inflation. This delegation has diluted the coherence of the prudential framework and blurred the lines of accountability between co-legislators, the Commission, and the supervisory community.

The same dynamic appears in the field of retail investor protection, most notably with the Regulation on packaged retail and insurance-based investment products (PRIIPs). The methodology for calculating performance scenarios and costs has been amended several times through RTS revisions, reflecting a technocratic tendency to regulate by numerical detail rather than by principle. Each modification forces financial institutions to redesign disclosure templates, generating an unstable foundation for compliance and confusion for consumers.

In sustainable finance, the Sustainable Finance Disclosure Regulation has extended this practice to an even greater degree. While the Level 1 regulation contains relatively general principles, the RTS specify prescriptive templates and quantitative indicators that often exceed the data or methodological capacities of financial market participants. The result is a complex, technically demanding framework that is difficult to apply consistently and to interpret meaningfully from an investor perspective.

Finally, the European Market Infrastructure Regulation and the Markets in Financial Instruments Directive II (MiFID II) exemplify the cumulative effects of Level 3 guidance. The ESAs and European Securities and Markets Authority have published hundreds of Q&As and supervisory statements to interpret the implementation of RTS provisions. While these instruments provide short-term clarity, they also generate a quasi-legal corpus of 'soft obligations' that differ across NCAs.

By contrast, in jurisdictions such as the UK and the US, regulators operate within principles-based statutory mandates that allow them to issue or adjust detailed rules directly, without relying on the proliferation of delegated legislation. Financial regulators in the UK, like the Prudential Regulation Authority and Financial Conduct Authority (FCA), can adapt technical requirements through consolidated rulebooks. So too can regulators in the US, such as the Federal Reserve, Federal Deposit Insurance Corporation, Options Clearing Corporation, and the Securities and Exchange Commission (SEC).

The European experience thus reveals a paradox: in attempting to ensure technical precision and harmonisation, the system has multiplied regulatory layers, resulting in a dense web of RTS, ITS, and guidelines that complicate implementation and weaken legal certainty. Over-delegation to Levels 2 and 3 has transformed the EU regulatory framework into a self-perpetuating process of continual rulemaking (see Table 1). This is the first of the structural imbalances within the European model – one that stands in contrast with the opposite tendency, excessive concentration in Level 1, examined in the following section.

Table 1. Over-delegation to Levels 2 and 3: regulatory inflation and complexity

Regulatory area	EU example (affected level)	Problem identified	Equivalent in the US and UK	Analytical observation
Prudential regulation: insurance	Solvency II: extensive delegated acts and EIOPA Guidelines on capital models, risk modules, and reporting templates	Excessive reliance on Level 2 and 3 rules, generating high administrative costs and compliance complexity	UK: the PRA issues prudential rules directly under a high-level statutory mandate	Illustrates regulatory inflation, driven by narrow legislative mandates at Level 1
Prudential regulation: banking	CRR/CRD IV–V: large number of regulatory and implementing technical standards covering reporting, internal models, large exposures, etc.	Fragmentation and opacity – the industry struggles to navigate an ever-growing body of secondary legislation	US: Fed/FDIC/OCC specify details via consolidated rulebooks under broad legal frameworks	Shows how detailed Level 2 mandates dilute clarity and consistency
Retail investor protection	PRIIPs Regulation: methodologies for performance scenarios and cost calculation repeatedly amended through RTS	Continual amendments and shifts in interpretation	UK: FCA applies a principles-based disclosure regime under its Handbook	Exemplifies technocratic overload undermining legal certainty and user understanding
Sustainable finance	SFDR: prescriptive disclosure templates and quantitative indicators set in RTS co-drafted by the ESAs	Excessive technical detail beyond what investors can usefully interpret	UK and US: sustainability disclosures remain more principles-based	Demonstrates that over-specification can hinder rather than enhance transparency
Market conduct and reporting	EMIR and MiFID II reporting obligations operationalised through numerous RTS and Q&As	Proliferation of guidance at Level 3 creates legal uncertainty and supervisory divergence	US: Commodity Futures Trading Commission and SEC issue limited technical guidance rather than hundreds of Q&As	Reveals how micro-management at Level 3 erodes harmonisation

Note: CRR = Capital Requirements Regulation; CRD = Capital Requirements Directive; EIOPA = European Pensions Insurance and Occupational Pensions Authority; EMIR = European Market Infrastructure Regulation; ESA = European Supervisory Authorities; FCA = Financial Conduct Authority; FDIC = Federal Deposit Insurance Corporation; MiFID II = Markets in Financial Instruments Directive II; OCC = Options Clearing Corporation; PRA = Prudential Regulation Authority; PRIIPs = Regulation on packaged retail and insurance-based investment products; RTS = Regulatory Technical Standards; SEC = Securities and Exchange Commission; SFDR = Sustainable Finance Disclosure Regulation.

Source: Author's compilation.

THE RIGIDITY OF LEVEL 1 LEGISLATION: OVER-SPECIFICATION AND LACK OF ADAPTABILITY

If excessive delegation to Levels 2 and 3 produces a dense and fragmented regulatory landscape, the opposite phenomenon – excessive concentration of detail in Level 1 legislation – results in rigidity and institutional inertia. This structural feature of the EU framework stems from the political economy of co-legislation: in order to secure agreement among Member States and the European Parliament, negotiators often codify highly specific technical provisions directly into the primary legislative text. Such over-specification is intended to prevent future regulatory drift and to reassure national constituencies. But it has the unintended consequence of locking technical detail into legislation that is extremely difficult to amend.

The result is a framework that lacks the agility to adapt to technological innovation, market developments, or prudential recalibration. Whereas in jurisdictions like the US or the UK, independent regulators can update parameters within their statutory mandates, in the EU even seemingly technical modifications require a full legislative process involving the European Commission, Parliament and Council. This difference has become increasingly evident in fast-moving policy areas such as financial markets, payments, and sustainable finance.

A prominent example is found in MiFID II/Markets in Financial Instruments Regulation, which set in Level 1 legislation highly detailed provisions on trading venue transparency, tick sizes, position limits, and data reporting. These parameters, by their nature, require continual adjustment to reflect technological progress and changes in market structure. In the UK, the FCA can revise such parameters through secondary rulemaking. In the EU, however, any amendment must go through the political legislative process, often taking several years. This creates a form of legislative lock-in that undermines the capacity for responsive market oversight.

The same rigidity appears in the Central Securities Depositories Regulation. When the US decided to shorten the settlement cycle to T+1 (day after the trade date), the SEC implemented the change through delegated rulemaking. In the EU, achieving the same outcome would require amending the regulation itself. The need for co-legislators' agreement on an operational issue exemplifies how the current system ties regulatory responsiveness to the slow pace of political negotiation.

In the prudential domain, the CRR embeds key prudential ratios – including the net stable funding ratio and the liquidity coverage ratio – directly in Level 1. This approach ensures legal certainty but eliminates flexibility: any recalibration of these ratios in response to

market conditions or international standards (such as Basel III revisions) necessitates a full legislative amendment. This structural rigidity was evident during the Covid-19 crisis, when even temporary prudential adjustments required the adoption of a formal 'CRR Quick Fix' amendment through the legislative procedure, albeit in an accelerated timeframe. While this demonstrated that the EU could act with relative speed in crisis situations, it still contrasts with jurisdictions like the US, where prudential regulators can modify such parameters through agency rulemaking within their statutory authority, allowing for more immediate adaptation.

A similar rigidity can be observed in payment services. Under the Payment Services Directive, the requirements for strong customer authentication (SCA) and a detailed list of exemptions are enshrined in the directive. As a consequence, even technical adjustments – for instance, threshold revisions or exemption criteria – require reopening the legislative text. The FCA, by comparison, can adjust such parameters through its Handbook, ensuring a balance between consumer protection and innovation.

Finally, the EU's approach to sustainability reporting under the Corporate Sustainability Reporting Directive follows the same logic of legislative over-precision. The scope, metrics, and disclosure requirements are anchored in Level 1, leaving little flexibility to adapt to evolving data availability, methodological standards, or market practices. This rigid structure risks making the sustainability framework outdated before it is fully implemented.

Collectively, these examples reveal a structural weakness: the EU's dependence on detailed primary legislation as a substitute for supervisory authority. While the intent is to safeguard democratic legitimacy and harmonisation, the outcome is a rulebook that cannot evolve at the speed of financial markets. In contrast, systems where supervisors are entrusted with clear mandates and strong accountability mechanisms – as in the UK or the US – can balance flexibility with oversight.

This excessive concentration of technical detail in Level 1 thus represents the mirror image of over-delegation (see

Table 2). Whereas the first pathology leads to regulatory inflation and complexity, the second produces legislative inertia and loss of competitiveness. Together, they reveal the central paradox of the EU's regulatory model: an abundance of rules combined with limited adaptability.

Yet, these two dynamics can be reconciled through a more principles-based Level 1 design and stronger, more autonomous European supervisory institutions capable of exercising delegated discretion within clear boundaries.

Table 2. Excessive concentration in Level 1: rigidity and lack of regulatory adaptability in the EU

Regulatory area	EU example (affected level)	Problem identified	Equivalent in the US and UK	Analytical observation
Market structure	MiFID II/MiFIR: trading venue transparency, position limits, tick sizes, and data-reporting parameters set in Level 1 legislation	Over-specification in primary law makes technical adjustments politically cumbersome	UK: FCA can amend microstructure parameters directly under secondary rulemaking powers	Demonstrates the EU's legislative lock-in and limited room for adaptive supervision
Post-trade infrastructure	CSDR: shortening the settlement cycle from T+2 to T+1 requires amendment of the regulation	Even operational changes depend on co-legislators' agreement	US: SEC implemented T+1 through delegated rulemaking	Illustrates structural rigidity and loss of competitiveness due to legislative inertia
Prudential banking regulation	CRR: NSFR and liquidity parameters are embedded in Level 1 text	Any recalibration needs a full legislative procedure	US: Fed/FDIC/OCC modify such ratios via supervisory rulemaking	Reveals how embedding technical ratios in primary law slows policy responses
Benchmarks	Benchmarks Regulation: detailed authorisation, governance and transition rules set in Level 1	Lack of flexibility for amending scope or recognition mechanisms	US: SEC/Commodity Futures Trading Commission can redefine oversight conditions through rule changes	Typifies over-legalisation of technical matters better suited for regulatory discretion
Payments and consumer protection	PSD2: SCA and exemptions enshrined in the directive	Technical and operational updates (e.g. thresholds, exemptions) require legislative revision	UK: FCA adjusts thresholds and exemptions via its Handbook	Shows the inability to adapt quickly to technological innovation and market evolution
Sustainability-related disclosures	CSRD: detailed metrics and reporting scope fixed in Level 1	Future market or data-availability changes require legislative reopening	UK: FCA and BEIS adjust disclosure content through secondary instruments	Exhibits legislative rigidity even in fast-moving policy domains

Note: BEIS = Department for Business, Energy and Industrial Strategy; CRR = Capital Requirements Regulation; CSDR = Central Securities Depositories Regulation; CSRD = Corporate Sustainability Reporting Directive; FCA = Financial Conduct Authority; FDIC = Federal Deposit Insurance Corporation; MiFID II = Markets in Financial Instruments Directive II; MiFIR = Markets in Financial Instruments Regulation; NSFR = net stable funding ratio; OCC = Options Clearing Corporation; PSD2 = Payment Services Directive 2; SCA = strong customer authentication; SEC = Securities and Exchange Commission.

Source: Author's compilation.

RECOMMENDATIONS FOR RECONCILING THE TWO PATHOLOGIES

The two pathologies described above – over-delegation to Levels 2 and 3 and excessive concentration of detail in Level 1 – are not mutually exclusive. They coexist because of a deeper structural feature of the EU regulatory framework: the coexistence of 27 NCAs responsible for supervision in most areas of financial regulation. With the notable exception of significant credit institutions under the Single Supervisory Mechanism, the enforcement of EU financial law remains decentralised.

This fragmentation explains why EU legislation tends to be highly prescriptive. Detailed rules at Levels 1 and 2 act as a substitute for centralised supervision, limiting the discretion of NCAs and safeguarding the integrity of the single market. Even under the current dense framework, however, supervisory divergence persists – as evidenced by differences in national application, enforcement intensity, and interpretative practices.

Acknowledging this institutional reality is essential. The demand for detailed regulation is not simply a technocratic excess; it reflects a functional response to the absence of unified supervision. A principles-based framework without corresponding centralisation of supervisory powers could inadvertently widen divergences across jurisdictions. Therefore, any move towards a more adaptive and principles-based system requires, as a precondition, a reform of governance and a greater pooling of sovereignty among national authorities and the ESAs.

1. Short-term priorities: reduce regulatory clutter and improve convergence

In the short term, structural reform is politically unrealistic. The focus should instead be on streamlining the existing rulebook and enhancing supervisory convergence within the current institutional setup.

A first step would be to review and rationalise Level 2 legislation – eliminating duplicative or obsolete RTS and ITS that no longer serve their intended purpose. Many of these technical standards have accumulated over time without systematic evaluation, contributing to regulatory opacity rather than clarity. The European Commission's recent decision to 'de-prioritise' 115 Level 2 acts until October 2027 underscores this problem

but falls short of a true solution. By delaying rather than eliminating superfluous regulations, the Commission perpetuates regulatory uncertainty while failing to address the core issue of excessive technical rulemaking. Rather than merely postponing measures deemed 'non-essential', a more coherent approach would be to repeal them outright.

In a second step, the ESAs should intensify the use of peer reviews to benchmark national supervisory practices and identify persistent divergences in implementation. The results of these reviews could be discussed at the Economic and Financial Affairs Council (ECOFIN), integrated into the European Semester process, and followed by targeted recommendations. This mechanism would strengthen convergence through soft coordination rather than the formal transfer of competences, gradually aligning supervisory cultures and expectations across Member States.

2. Medium- to long-term vision: reform governance and delegate autonomy

In the medium to long term, however, the sustainability of the current model depends on a more profound re-engineering of governance. The EU cannot indefinitely rely on legislative detail to compensate for supervisory fragmentation. A credible transition towards a principles-based architecture requires empowering the ESAs with clearer, stronger, and more autonomous rulemaking and coordination mandates. This should be combined with robust accountability mechanisms before the European Parliament and the Council.

Any such strengthening of the ESAs' rulemaking role must, of course, remain compatible with the Meroni doctrine. This implies that greater autonomy cannot take the form of unfettered discretion, but must operate within clearly defined objectives, limits and evaluation criteria set out in Level 1 legislation.

Meroni-consistent empowerment would therefore focus on expanding the ESAs' ability to calibrate and update technical parameters within a tightly framed mandate, supported by strong accountability before the European Parliament and Council. In practice, this means improving the quality and structure of delegation – rather than altering the constitutional balance of the Treaties – so that the ESAs can exercise technical judgement where political co-legislation is neither necessary nor efficient.

Level 1 legislation could then concentrate on objectives, principles, and boundaries of discretion, while technical parameters and recalibrations could be adjusted through ESA rulemaking within these limits. This would align the EU's regulatory framework with the adaptive governance models of the UK and the US, where supervisors are granted broad delegated powers but remain subject to transparency and judicial oversight.

Ultimately, the distinction between short- and long-term measures underscores a key insight: simplification and flexibility are sequential, not simultaneous, reforms. In the immediate term, simplification should aim at coherence within the existing structure; in the longer term, flexibility must rest on institutional strengthening. Only by sequencing these reforms can the EU evolve from a system of legislative micromanagement into one of principled, adaptive, and integrated financial governance.

CONCLUSIONS

The evolution of the EU's financial regulatory system reflects an enduring tension between pursuing harmonisation and preserving flexibility. The Lamfalussy architecture, once conceived as a pragmatic compromise between politics and expertise, has gradually become a source of both regulatory inflation and legislative rigidity. Excessive delegation to Levels 2 and 3 has generated a dense web of technical standards and soft law that complicates compliance and blurs accountability. Meanwhile, excessive detail in Level 1 legislation has locked the system into a pattern of procedural inertia.

These two distortions are not contradictory but interdependent: over-delegation compensates for political gridlock, and over-specification compensates for fragmented supervision. The result is a framework that is simultaneously elaborate and static – abundant in rules, but slow to adapt. Recognising this structural paradox is essential for designing a more coherent and credible regulatory model.

In the short term, the EU should focus on **simplification within institutional constraints**: pruning redundant Level 2 acts, consolidating reporting requirements, and strengthening supervisory convergence through systematic peer reviews and their discussion at ECOFIN and in the European Semester. These pragmatic steps would improve coherence without requiring immediate treaty or governance reform.

In the medium to long term, however, the EU must confront the limits of its current architecture. Sustaining simplification and adaptability will require **recalibrating governance**, by granting the European Supervisory Authorities clearer mandates, greater operational autonomy, and stronger accountability mechanisms. Only with this institutional foundation can Level 1 legislation become genuinely principles-based, and the rulebook evolve without recurring to legislative micromanagement.

Ultimately, simplifying and rebalancing EU financial regulation is not about deregulation, but about clarity of purpose and coherence of competences. The challenge is to construct a system that preserves democratic legitimacy while enabling timely and proportionate adjustment to market and technological change. By sequencing reform – **streamlining first, empowering later** – the EU can move towards a financial regulatory framework that is stable and adaptive as well as credible and comprehensible.

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