GLOBAL FINANCIAL FRAGMENTATION: CAN PROGRESS BE MADE?

The Covid crisis has not led to a financial fragmentation at the global level so far, but challenges and concerns for international cooperation remain. Multilateralism is the most efficient way to solve common issues.

1. The global financial system has not fragmented in the Covid crisis

1.1 Rapid and coordinated policy responses to the Covid crisis prevented fragmentation

An official is cautiously optimistic, as the financial system was not at the centre of the crisis. After a shaky start in March 2020, it stabilised due to international coordination and swift public policy action to support the economy. Since then, supervisors and regulators have monitored the evolution of the crisis and provided flexibility where needed, while markets have generally responded positively to the strong public support given to the real economy. This resulted in unexpectedly high asset prices in such a severe crisis.

1.2 A great deal of progress has been made

A regulator noted that this is still an all-male panel, which shows that one area of fragmentation still exists within the financial services system. However, compared to the 2008 financial crisis, much distance has been travelled. Common rules were set up to strengthen the capital, liquidity or shock absorption capacity of the financial systems and global fragmentation decreased. Cooperation amongst regulators is as good as ever. Issues are discussed with standard setters and taken seriously. Progress has been achieved. However, there is still fragmentation, and the potential for additional fragmentation.

An industry representative stated the 2008 crisis did not go to waste as infrastructure was built, and so it would be great if this became a catalyst to get people around the table to work towards the next point. One problem is that the 2008 crisis was specific and clear, whereas this one had different vectors.

1.3 International regulatory reforms introduced after the Global Financial Crisis (GFC) have built up resilience

An industry representative said the intersection between Brexit and Covid is interesting. If Covid had happened in 2008 the impact would have been much worse and that is in large part due to support from the public side and the lessons learnt during the post-financial crisis, which have helped the financial system and the global economy. Congratulations are due to the public side on global coordination. The amount of work in coordination has been a positive.

1.4 Deference between regulators has increased

A regulator stated that IOSCO has 125 members globally, regulating more than 95% of the world's capital markets. A 2020 report on deference and fragmentation found an increased use of deference[1]. It might be counterintuitive, but deference between regulators significantly increased with enhanced cross-border capital flows. It is not that there are increasing signs of fragmentation, but there is the context of the pandemic. IOSCO ramped up its internal board meetings and made a public commitment to keep markets open, as the functioning of equity, credit and funding markets was vital for the real economy. That announcement ensured that markets did not close down and tried to address potential fragmentation.

1.5 International standard setters (IOSCO, FSB, Basel Committee) help with market fragmentation

A regulator noted that on pandemic and non-pandemic-related issues, the work done by international bodies helps with market fragmentation. It may not be perfect, but it has been shown to help. Important work with other standard-setting bodies like the Basel Committee helped to put the final implementation phases of the margin requirements for non-cleared derivatives in place and ensured that fragmentation did not happen. Guidance was made available on the application of IFRS 9, as that would have resulted in more fragmentation. Less glamorously, the setup was announced. Depository fund members float in real time, so encounter measures in their jurisdictions, and the measures taken meant that a depository could be populated for other members to see, which helped in not fragmenting markets and aligning standards, even without producing standards. That gave flexibility in areas like annual general meetings (AGM), disclosure options and on-site inspections, but also for voluntary control mechanisms.

1.6 Reasons for optimism

A Central Bank official thought there is good news, but also development areas. Structures established 10 years ago for global cooperation and coordination in the financial sector came through Covid well. Information on experience sharing was key when the situation was unprecedented and trying to reach a common view was vital, as was collective risk assessment and action and the substantive coordination of regulatory flexibility and forbearance. Standard setters and the FSB agreed on principles for regulatory action, either delaying regulatory changes such as IFRS 9 or allowing temporary forbearance where it did not weaken the system. Putting back those measures should be coordinated and collectively discussed.

1. At the St. Petersburg Summit in September 2013, the G20 Leaders agreed that "jurisdictions and regulators should be able to defer to each other when it is justified by the quality of their respective regulatory and enforcement regimes, based on similar outcomes, in a non-discriminatory way, paying due respect to home country regulatory regimes."

These structures work because they recognise the inevitable heterogeneity of different structures, and that different legal systems make the rules, while bodies like the FSB and the Basel Committee cannot. Maybe one day the United Nations will be the global financial regulator. However, until then the system has to accommodate different structures and stresses, but that those actions were coordinated made a huge difference in contrast to 10 years ago. The test of that will come as the recovery phase is entered, public support schemes are withdrawn and the long-term damage to the economy and financial sector losses emerge. A collectively coordinated approach will be essential.

On the importance of the joint risk assessment and actions to address it, there has been market turmoil and stress, with disruptive call markets in March, as the financial markets adjusted to the pandemic and the likely economic impact. International structures were quick to assess risks, producing assessments and formulating a programme of work to address fragilities. That is now moving forward. It will be a test of the system whether a risk assessment can be agreed upon, with the necessary policy items to deal with vulnerabilities in non-bank finance and implement them consistently across jurisdictions. However, the situation is so far so good.

The other good is how the technology side is dealing with payments issues. The G20 and FSB have a great deal of work to do on the roadmap for improving cross-border payments, and on standards for systemic stablecoins, which raise fundamental questions, and those which deal with the role of money in jurisdictions. It is vital to avoid 'Uber-isation', where something takes hold quickly and is used at scale before regulators catch up.

An industry representative raised the issue of non-performing loans (NPLs), which are considered benign and under control; there will be some, but less than expected. They are not as worrysome now as in 2008. Meetings were held in Brussels and the UK about progressing the securitisation market so that banks can move back books into the market and free up balance sheets to lend to the real economy. The opportunity is known, and there is room for optimism.

1.7 Basel and LIBOR reforms are good examples of international coordination

An industry representative stated that global coordination on LIBOR, a major financial services project for firms, has been significant. The UK will meet Andrew Bailey's deadline at the end of 2021 and is in execution mode. The UK's leadership o LIBOR globally, has been top class.

Basel is a good example of coordination. The Basel Committee jointly decided to postpone implementation by one year. There has been no decision to postpone it further, and so it should be done according to the timelines indicated. The EU will put forward a proposal in the middle of 2021. Covid has caused a timetable blockage in the College of Commissioners, but that is the proposed schedule, and it will be followed. The average time to pass such a proposal through the Union machine is two years minimum, which shows the timing for adoption. Then there will be a period for implementation. These timelines have been made known to the Basel Committee and will not be changed.

A regulator indicated that the key sense for recovery is optimism, but not complacency. Existing international infrastructures must be appropriate, such as IOSCO, CPMI and the FSB, as it matters for producing standards, information sharing, agreeing to disagree or addressing issues. Action may be required globally in non-finance areas like data localisation technology, and others in policymakers' broader remit. Examples from the financial space allow for learning.

2. Future challenges for international cooperation

2.1 The Covid crisis shows potential for ongoing fragmentation

A regulator noted that the position of the economic cycle can add to fragmentation. With the market turmoil in March, regulators were quick to speak of forbearance and a great deal of it happened. There have been many different measures, small and large, and some could have been better coordinated. Everyone mentioned that buffers are there to be used, but people understood different issues by that. Some thought that banks needed to support the real economy and ensure credit flows no matter what. Others said that buffers are cushions to be used for banks in trouble. These are two different issues. If the economic cycle is at the moment when things turn sour, national jurisdictions, regulators and economies tend to look after themselves. The Covid crisis showed the potential for continued and ongoing fragmentation.

2.2 Brexit is fragmentation

An industry representative stated that whether it is the cost of doing business or more permanent fragmentation is often discussed internally. Many are dealing with Covid issues, but Brexit is troubling others. People are adapting. Some of it is the cost of business, but some is real fragmentation in financial services and the real economy. National tensions may harden attitudes in dealing with cross-border equivalence and finding compromises, as there have been some disagreements in dealing with Covid and that is a worry.

An industry representative observed that competitiveness in European financial markets is deteriorating compared to other major financial centres, due to Brexit and the lack of harmonising regulations. The cost/income ratio of European banks is higher than in the US and for Asian banks. EU/Japan economic partnership agreements have been successful at bringing consultation before implementing new regulations. This coordination should be expanded globally, with policymakers moving towards global regulatory harmonisation, to achieve economic recovery, a carbon-neutral society and financial stability.

2.3 Financial fragmentation could arise if exit strategies are not coordinated

A regulator considered that problems with regulatory coordination could arise if the post-Covid recovery is characterised by wide divergences across the world economy. Pressure can build on regulators to keep support measures too long, in a way that is not prudent, or to postpone the necessary structural reforms to support the underlying resilience of the system. There may be differently perceived trade-offs between short-term supply measures and longer-term reforms in different regions that could result in pressure for regulatory deference and fragmentation, so it is vital to ensure that the right choices are made.

As to whether a tapering of public measures could result in tensions between states, coordination was deemed good going into the crisis especially in the financial sector. Exiting the crisis will entail asymmetrical impacts and so there will be different pressures and pacing from the withdrawal of support measures. An industry representative considered that efforts should be made to ensure that does not happen, as if it is not focused on, it will.

2.4 Different sources of concerns

2.4.1 A tricky political environment

A policymaker stated that the political context is not great. Trust between countries across the world took a hit following the global financial crisis and has not yet fully recovered. The reaction to Covid has shown that trust has reduced significantly. It is not an ideal environment, but it has been like this for a while. The financial sector will have to work to identify the benefits of common responses and convince politicians that common responses are best. There are limits to that and it is important not to be naïve, but to be realistic with the private sector and not overpromise on delivery or under-promise either. It is a tricky environment, but the EU has tight coordination methods in place, even at local level, which can work to mitigate risks.

2.4.2 Increasing protection needs and different mindsets of national populations

A Central Bank official noted that the pandemic has focused governments on risks imported across borders and the protection of national populations, and on the balance between localisation and overseas procurement in supply chains. This is obviously most notably in health but not exclusive to it. Some of the political sentiment which has been generated around that, which is as powerful as government's first priority is to protect citizens' lives, may spill over into other areas, and that is something to watch.

An industry representative stated that these comments are striking. The mood in the UK is different to that in Ireland. People's mindsets coming out of Covid will be different in terms of how they tackle the future. There are worries about whether it is the end of the beginning or the beginning of the end, and false optimism where people feel Covid is behind us. Ultimately, there will be the recovery and the bill to pay, which is not being talked about yet. Paying for the financing of the crisis will strain politicians and smaller economies.

Three countries are doing well in vaccine rollout: the US, the UK and Israel. Everyone else is playing catch up and there will be spikes. There are questions of the next variant or what winter brings, so there is still a way to go, and it is important not to be complacent about financial preparedness, given that institutions still struggle with growth and low interest rates. There are good things in place, but there are many worries about the future in terms of shocks to the system, geopolitical considerations and more.

2.4.3 The international banking crisis management evolution highlights a trend of ring-fencing issues

Additional requirements on loss-absorbing capacity were agreed on to make systemically global banks resolvable. The international framework also focused on stronger standards with territorial approaches to prudential supervision and crisis management, resulting in a duplication of supervisory and reporting requirements.

An industry representative stressed that it is not a contradiction if the public side thinks global coordination is improving and the private side thinks it is deteriorating, as much has been achieved, especially with prudential regulation in Basel III and capital liquidity. But following a decade of perceived global financial integration, there is a trend of localisation in a number of areas, be it as a consequence of Brexit or in the area of crisis management framework due to frictions between home /host countries. Loss-absorbing capacity has to be localised to a significant extent at each subsidiary. Considering the last mile and prepositioning of resources, an internationally consistent approach to lenders of last resort functions would help enhance the banks' resolution planning. The public side must agree that plans are credible and can be executed, maybe going beyond recovery and resolution planning into operational resilience, which is new and broad and important to have a common understanding of. The scope of what supranational bodies focus on should expand, because supranational regulators, together with national bodies, have responded to the crisis excellently, as with the overall response to the financial crisis, and these practices should be carried forward.

2.4.4 The size of Central Banks balance sheets

An industry representative considered that another question is the expansion of central bank balance sheets, which many economists see as taking central banks close to governments, in terms of governmental funding and what that means. The issues are in different vectors. Taking advantage of this crisis will be difficult to do or will require an additional amount of imagination.

The Chair asked if the build-up of debt in many European countries is a worry. An industry representative stated that the size of central bank balance sheets is, as is the misallocation of capital. If there is credibility and the ability to print money, that may go away. Having access to domestic savings, as in Japan, may make it possible to have a debt to GDP ratio of over 200%. Over the last 15/20 years, 60/70% of global GDP growth has been in emerging market countries. Many of the Basel and other rules have made it more difficult for emerging markets to access capital, and developed markets need economies like Brazil, China and India to grow rapidly. When they do not, global growth is anaemic. The question is if the price mechanism functions when there are negative yields of minus-30, high-growth emerging market countries borrowing at 9% and excess savings going into different parts. Smart economists can figure that out.

2.5 New areas and pending issues where more global coordination is required

2.5.1 The future will be driven by new topics

An industry representative stated that emerging issues and technologies need to be appropriately considered to avoid further fragmentation. Next to operational and cyber resiliency and digital assets, there is a need to focus on sustainable finance and to help investors to understand the relevant context and details. A further focus has to be on the growing importance of Non-Bank Financial Institutions, on market conduct and financial crime. These themes must be identified, and work agreed to respect national interests within a global system.

2.5.2 Sustainable finance: global convergence on ESG standards is challenging

A Central Bank official noted that climate is an issue where, probably for political reasons, the structures are behind where they should be. The Task Force on Climate-Related Financial Disclosures (TCFD) is there for disclosure, but the standards need more to enable the cross-border financial sector to price risk and assess reward as governments tackle climate change. The International Financial Reporting Standards (IFRS) proposal for an international body to coordinate sustainability standards is a step forward.

An industry representative expressed his concern for the future on Environmental, Social and Corporate Governance (ESG). Addressing climate change and directing capital towards facilitating the transition to net zero carbon emissions calls for ambitious international solutions. ESG and fragmentation are related to each other as governments encourage ESG-related investments in response to the pandemic and fiscal stimulus packages are implemented on a national discretion basis. There is a huge challenge globally in reducing greenhouse gases and transforming to carbon neutral. There are uncertainties, such as how and in what time horizon this can be achieved. Short-sighted aggressive campaigns like greenwashing in finance could harm the transition, for which most corporates are thinking of initiatives and investment in renewable energy, together with public investment.

Economic recovery from COVID-19, which is the original purpose of the fiscal package, could be an opportunity. Banks and policymakers must support sustainable transition pathways with appropriate liquidity provision. Europe is a world leader in ESG, with the EU's sustainable finance strategy. Regulations for promoting this should be harmonised globally. Regulatory harmonisation is critical for a common understanding of the rules and for categorising activities from an ESG perspective. Different global economic substances and features may cause understandable confrontations or disagreement in coordination amongst countries. Reaching realistic agreement requires focus on high-level global standards, rather than detailed prescriptive rules. The EU's international platform for sustainable finance will have a key coordination role.

2.5.3 Data and technology: For a G7 digital and technology forum?

A Central Bank official noted that there are areas of data and technology which are not the responsibility of financial sector regulators, but where what is decided will go to fragmentation and localisation. A cross-sector group of international corporates have suggested to the G7 that something like the FSB be established as a technology and data forum to coordinate emerging convergence. On cloud and AI, data will create financial sector fragmentation if authorities cannot be brought in or do not work together.

An industry representative stated that an issue in the US is the democratisation of data allowing retail players to play in the markets, blurring the lines between trading, investing and video gaming.

The Chair asked about support for a type of technology G7. A Central Bank official stated that a proposal had been made to the G7, but it could be the G20. FSB experience suggests a forum in which standard setters and regulators work under a broad political umbrella to try and line up and discuss areas where they cannot. There may be places where trade-offs cannot be made but trying to line up on standards where future fragmentation is likely and the financial sector will be affected by what is useful.

2.5.4 Deference and CCPs

A Central Bank official stated that it is not clear that much progress has been made on deference and CCPs. All possible progress may have been made due to political blockages as well as technical ones, but it is a balance and a trade-off, and jurisdictions will put the trade-off in a different place.

2.5.5 Recovery and resolution of failing banks at the global level

A regulator noted the reference to prepositioning. Even if Total loss-absorbing capacity (TLAC) standards try to tackle the issue, there is an inherent conflict. It must ensure where capital is held, so there is thus a fair share for all the jurisdictions for global international banks and also ensure the free fungibility of the capital and liquidity in case it is needed in an area of these banks. This issue has not been solved and there is still fragmentation.

An industry representative thought that a reliable, internationally consistent approach to central banks' lender of last resort role will be crucial as a key enabler of an effective and credible bail-in tool. This should encourage host authorities to limit excessive pre-positioning requirements, as intended by the FSB in designing the TLAC framework. Consequently, the increase in costs for banks, which would over time feed through to the economy, would be limited. Clearly this is important for supporting the recovery.

3. Multilaterism remains the most efficient way to find solutions for common issues

3.1 Fragmentation will always exist for structural reasons

There will always be fragmentation, for various reasons, according to a regulator. With a global supervisor, a global tax base and global government, it might be possible to dream of fully integrated global financial systems, but that is not there. The importance of integrated global financial markets should not be underestimated, but they are not the most important consideration in the governance of the global system. The system is characterised by different national boundaries, reflecting different legal and tax frameworks, different governments, and different accountability frameworks, so there will always be a trade-off between efficiency gains achieved by integrating markets across borders, and possible strategic or financial risks created by the provision of services by entities supervised in other jurisdictions. In that trade-off fragmentation is to be found.

The IOSCO report which fed into the FSB work concluded that such fragmentation is almost inevitable in the system and is not down to protectionism in the narrowest sense but to the fact that as long as there are different jurisdictions frictions will exist. Regulators must optimise the benefits of integration, subject to the natural constraints on process. The public side has seen more coordination not less. If the private sector sees it, it is due to market behaviour and not because of a failure of regulators to work together.

3.2 Fragmentation can have detrimental effects

Financial market fragmentation is seen as a significant challenge for regulatory authorities and policymakers because it might entail less competition, higher costs of capital and reduced availability of services.

An industry representative stated that the private sector would love to see consistent global implementation for international regulatory reforms. For global institutions with entities in different jurisdictions, running different processes and implementing different rules at different times brings fragmentation to the institution and a real cost. It seems like a small point in terms of rollout consistency and implementation timetables, but when not adhered to it is a huge cost.

An industry representative stressed the importance of further developing the financial system, banking and non-banking, to the benefit of customers, and agreeing on global topics to support open markets. Implementation must be completed where not yet fully done, including on internal TLAC/MREL prepositioning, and clarity has to be established on open issues such as lender of last resort capabilities, to ensure that the work done is credible. The hope is that this resolution planning is never used but working towards a common goal will develop the financial system going forward.

An industry representative hoped that language can be found to remind people of the benefits of financial services. There tends to be a defensive tone but articulating how it can be a driver for global growth will help. That has been difficult to do since the financial crisis.

An industry representative appreciated how financial regulators' global coordination has helped with the unprecedented problems of COVID-19. Society is now tackling ESG issues, which require new global coordination. Further regulatory divergence may affect the competitiveness of the European financial market, with European banks' average higher cost/income ratio crucially affecting third country banks operating in Europe, who may look to allocate capital elsewhere if their EMEA business is not sufficient to maintain sustainable growth. That will have a consequent impact on clients through direct cost increases, poorer service quality and more limited choice.

The Chair noted that making European capital markets deeper, bigger and more liquid would have an effect on growth. If the EU can deliver its projects, it will create a dynamic which will be beneficial to everybody.

3.3 Switching from looking back to looking forward and fostering international cooperation

An industry representative considered this an opportunity to switch from looking back, as a great deal has proven to be effective, to looking forward and enabling the financial system on digitalisation, cyber, digital assets, the increasing use of AI and consumer protection. National self-sufficiency can be balanced in a globally consistent regulatory framework so there is a level playing field and common standards. With different legal regimes, it can be impossible to have one standard, so the equivalence regime should be outcome-based to avoid a struggle over line-by-line equivalence; instead, it should focus on the outcome in achieving an overarching goal.

It is important to be pragmatic and forward-looking. This is owed to the next generation. The last decade was mainly about recovery from the financial crisis. The financial system must be made robust and stable enough to help the recovery from this crisis and to accommodate changes from the technological revolution, the new needs of investors and borrowers, and the overall economy. There is too much focus on looking back while being overwhelmed by the future. Prioritising how to create the new environment is vital.

A regulator agreed that it is vital to be forward looking, while finishing what was started. Basel III's too big to fail regulations still lack full efficiency and effectiveness. Areas such as non-bank financial intermediation, hedge fund leverage and money market funds are still on the table. The industry should take on new things but finish tackling the proven inefficiencies and vulnerabilities that were identified.

An industry representative agreed that there are actions which could foster further international integration to the benefit of each country, given the global financial system remains highly interconnected, reflecting both supply and demand needs across jurisdictions.

Authorities must follow through consistently on the reforms already begun, such as the completion of the Banking Union, the TBTF reforms and a consistent implementation of Basel III. Stepping up efforts to remove existing impediments to cross-border consolidation is the best route to attain financial integration.

An industry representative urged policymakers to move towards global regulatory harmonisation and enhance mechanisms for continuous and systematic cross-border cooperation, with appropriate deference for national and industry idiosyncrasies, so that all enterprises can thrive without being burdened unnecessarily with the cost of incremental compliance.