Financial Fragmentation

Key Considerations

Context

Since the 2008 global financial crisis, financial fragmentation has become an increasingly common feature across international markets, characterised by drastic decreases in cross-border holdings and by strong disparities among banks’ core credit spreads, especially within Europe. While fragmentation can sometimes benefit some individual countries on the national level in the short-term, it is harmful to global economic recovery and stability in the long-term.

The OECD Committee on Financial Markets met with representatives of the financial services sector on the occasion of the OECD Financial Roundtable on 17 October 2013, where the discussion focused on the status and key drivers of financial fragmentation, as well as the measures to cope with it. In follow-up, this BIAC paper contributes key considerations which we believe should be taken into account in OECD work in this area.

Defining fragmentation

There are differing interpretations as to what financial fragmentation actually means – for example, whether it refers to the differences between national and regional financial markets and pricing levels, diverging regulations between different jurisdictions, inconsistencies between financial regulations even within the same jurisdiction, and so on. Some also associate financial fragmentation with financial protectionism and ring-fencing.

On the other hand, differences in pricing levels or terms of finance should not be considered fragmentation to the extent they follow from different business models, firm-specific risk, or from the risk premium related to relative domestic economic performance, rather than differences in regulatory regimes or different interpretations of global standards.

The OECD could assist in clarifying the definition and scope of the notion of financial fragmentation.

The reasons for financial fragmentation

Financial fragmentation is generally a result of uncoordinated and/or extraterritorial regulations. Gold-plating of the internationally-agreed regulatory programme by national and regional jurisdictions, in addition to other diverging measures, is leading to inconsistencies. In some countries, regulators have encouraged banks to boost national lending at the expense of cross-border operations, while in others foreign banks are required to restructure their operations in one jurisdiction into separately capitalised and funded local holding companies.
The consequences of financial fragmentation

Uncertainty:

Inconsistent and divergent regulatory measures create uncertainty which undermines financial institutions’ ability to conduct business. The diversification of regulation by different jurisdictions leads to increasing costs for banks, which be passed onto clients, in turn impacting on cross-border trade.

Deteriorating financial conditions and impacts on the real economy:

Perceptions about local sovereign debt, sovereign debt ratings and sovereign spreads together form an important driver for financial fragmentation. European banks’ core credit spreads are increasingly correlated with sovereign bond spreads: therefore banks are facing increasingly severe financing conditions and costs, which are ultimately passed on to the rest of the economy, aggravating economic crises. As a consequence, the financing costs facing firms in countries may not be related to the firms’ underlying economic credit worthiness; this is highly problematic and impedes economic recovery in affected jurisdictions.

Furthermore, the lack of a credible disentanglement of the performance of the financial sector and impacts on private sector prospects, from issues related with the fiscal performance of the public sector, notably in the Euro area, has in some cases led to increased fragmentation.

Reduced effectiveness of monetary policy:

In the case of the EU, financial fragmentation is a further challenge when facing a single EU monetary policy. The result can be a trapping of domestic economies in suboptimal interest rate regimes. The inability of expansionary monetary policy to support the most distressed areas, coupled with fragmented regulatory regimes to banks, results in further depressing of already-weak economic areas.

Directions for greater regulatory convergence

Divergence in regulation across jurisdictions does not call for uniformity of rules, but instead for an appropriate level of consistency in the principles used to determine regulatory outcomes. Consistency in the implementation of international commitments, notably the G20 programme for regulatory reform, is especially important. Consistency includes oversight, regulation and supervision, as well as the implementation of international commitments. This would enable financial institutions to operate and offer services cross-border without unnecessary impediments, while companies, investors and retail customers would be able to access those services safely and efficiently, benefiting economies.

Working together with the Financial Stability Board (FSB) and the International Organisation of Securities Commissions (IOSCO), the OECD can play an important role in facilitating the
development of a co-ordinated approach to cross-border regulation. Co-ordinated dialogue among global policymakers and regulators at the initiation of policymaking could minimise the potential rise of conflicting frameworks. Cost-benefit analysis should be conducted to avoid negative unintended consequences and fragmentation of markets. This calls for greater balance between financial stability, economic growth and returns on investment. Reasonable implementation timelines co-ordinated across jurisdictions would allow for a more orderly transition. A framework for continued dialogue and dispute resolution would facilitate re-convergence.

Greater attention should also be devoted to studying the links between the State and financial institutions - for example implicit guarantees or political influence in the banking sector.

By taking into account such considerations, the OECD is in a unique position to foster greater co-ordination of regulations and thereby reduce regulatory fragmentation and its negative consequences.