Augustin Guillermo Carstens

General Manager,
Bank for International Settlements

The quest for financial integration in Europe and globally

1. Introduction

Let me first thank Eurofi for inviting me to participate in this prestigious forum. Although the BIS is a global institution, we follow developments in the European Union very closely. This is not only because of the geographical location of our headquarters in Basel - just a few kilometres from the two largest European countries - but also because Europe and the European construction project are so important in the world economy and the global financial system

As you all very well know, over the last 10 years the international community has developed a comprehensive set of reforms that profoundly affect the regulation of financial institutions and financial market activity. The reforms aim to improve crisis prevention and crisis resolution mechanisms in order to make episodes of major financial instability less frequent and less costly.

Now that the bulk of the reforms have been completed, the priority is to ensure that they are adequately implemented. It is also time to evaluate whether they have been able to meet their objectives and to analyse how regulatory changes have affected the functioning of international capital markets. In particular, it will be necessary to analyse whether the financial system has become not only safer but also more able to support the orderly development of both domestic and international financial intermediation. In that context, the G20 has established as one of its policy priorities the analysis of possible signs of fragmentation that could jeopardise global financial market integration and the consideration of the appropriate tools to address it.

Integrated financial markets bring a number of social benefits. They help enlarge the opportunity sets of lenders and borrowers, increasing competition in the provision of financial services and offering possibilities to diversify idiosyncratic risks away from the national economies, thereby contributing to financial stability.

This last benefit is particularly relevant within a currency union like the euro area. A well functioning monetary union requires effective risk-sharing mechanisms that could help weaken the link between economic developments, the availability of finance and financial stability in each member country.

Yet, in addition to its benefits, international financial market integration also involves some costs. Integrated markets can transmit shocks and volatility. Sudden stops have macroeconomic costs. And internationally active financial institutions also need to be supervised and regulated comprehensively. In particular, the availability of adequate loss-absorbing resources is critical. Therefore, policymakers need to balance delicate trade-offs to reap the full benefits of financial integration while minimising potential costs.

In the rest of this presentation, I will first review possible ways to address market fragmentation at the global level. I will then focus on market integration within the euro area.

2. The global case

Although there is no commonly agreed definition of market integration, I consider it the ability of providers and users of financial services to operate on competitive terms in jurisdictions other than the one in which they are headquartered or located. Frequently used indicators of the degree of market integration are the size of international financial flows, the penetration of foreign players in local markets and price gaps for similar services or products in different jurisdictions.

In the analysis of financial integration, regulatory divergences are often mentioned as a major source of fragmentation. Indeed, diverse national rules may inhibit foreign participation in domestic markets. Those divergences may be produced by a number policy characteristics [1]:

- First, the incomplete or inaccurate implementation of internationally agreed regulatory standards that typically target internationally active firms.
- Second, domestic rules complementing international standards, such as structural measures on the banking side (such as separation of retail and investment banking activities in different legal entities) or ring-fencing measures for local subsidiaries of international firms.
- Third, the introduction of rules for financial activities performed by domestic firms in foreign jurisdictions (extraterritoriality), such as clearing location requirements for transactions denominated in the domestic currency but conducted anywhere.

Naturally, national choices may respond to domestic singularities or policy priorities in a context in which the structure of national economies and their financial systems diverge markedly. In other words, regulatory divergences can often be the consequence rather than the cause of the structural heterogeneity of the world economy. In fact, adapting financial regulation to national specificities may well help strengthen domestic financial systems and in that way enhance global financial stability.

A case in point is the ring-fencing measures of internationally active firms. For instance, the TLAC standard aims to appropriately distribute loss-absorbing and recapitalisation capacity within a group and provide for pre-positioning in material subsidiaries or subgroups [2].Furthermore, a number of host jurisdictions have established rules that require foreign banks to create intermediate holding companies grouping all interests in that jurisdiction and ask them to hold sufficient liquidity, capital and bail-in-able debt to cover their estimated local needs on both a going-concern and a gone-concern basis. Requiring the pre-positioning of the estimated loss absorption needs in the local company ensures that the normal operation and resolution of the local subsidiaries would not depend on the availability of funds provided by the foreign parent entity. That certainly protects, in principle, financial stability in the host jurisdictions. It may also help to limit the propagation of financial stability shocks across borders.

Yet ring-fencing also imposes costs on international banks, as they face constraints in seeking to efficiently manage the group resources. It could even be argued that those constraints may also affect the stability of the group as a whole, as the pre-positioning of a large part of the group resources in different legal entities could leave little room for the group to provide additional support to subsidiaries if the pre-positioned resources were to prove insufficient.

It has recently been proposed that consideration be given to replacing pre-positioning requirements with cross-border guarantees under which parent companies commit to support subsidiaries in case of need, both in normal times and in resolution[3].That would, of course, weaken the rationale for ring-fencing and allow international groups to centrally manage a larger amount of resources, thereby supporting their efficiency and promoting market integration. Yet work remains to be done to determine whether and how those guarantees could offer sufficient comfort to host authorities and, more broadly, to financial markets. This work is particularly relevant in situations where the parent company - the guarantor - might also be in trouble; where the legal enforceability of those cross-border contractual arrangements is in question; or where the regulatory and accounting treatment of the guarantees for both the parent and the subsidiaries is unclear. And guarantees have often proved to be less adequate than tangible equity in times of crisis.

Moreover, enhanced information exchange among authorities and better functioning of supervisory colleges and crisis management groups could reduce the need for extraterritorial and other unilateral actions to ensure financial stability and market integrity in all jurisdictions. Recent reports on market fragmentation by the Financial Stability Board[4] and the International Organization of Securities Commissions have spelled out those ideas, together with a concrete action plan [5].

Even in the sensitive area of ring-fencing, international cooperation may facilitate a better outcome. Stringent local loss absorption requirements are partly the consequence of a non-cooperative framework that resembles a prisoner's dilemma type of situation. No matter what foreign authorities do, domestic authorities prefer to require the pre-positioning of sufficiently large volumes of resources at the subsidiary level. But if all host authorities do the same, they risk creating rigidities in the allocation of resources that could ultimately affect the stability of the group as a whole.

A fully cooperative solution that would remove any need for ring-fencing is not achievable. But progress could undoubtedly be made within crisis management groups towards deciding on an allocation of resources within international groups that would strike a good balance between the need to protect stability in each of the host jurisdictions and the need to preserve sufficient flexibility for the management of the group as a whole.

3. The European case

The case for financial integration within currency unions is particularly strong. Arguably, the bar for an adequate level of financial integration is higher within a monetary area than across countries issuing their own currency. In particular, within a well-functioning monetary union there should be no strong links between economic developments in a particular jurisdiction and the value of banks' deposits in that jurisdiction. Otherwise, as we have seen during the recent euro area crisis, adverse shocks to specific economies may trigger outflows of deposits to other jurisdictions, causing extreme financial instability and creating politically challenging tensions within the monetary union.

Achieving that goal requires common risk monitoring, risk prevention and mutualisation arrangements like those foreseen in the banking union project. These include common supervisory and resolution mechanisms supported by a single resolution fund and, eventually, a common deposit guarantee scheme.

Yet a crucial complement of those public arrangements would be a truly integrated banking industry in which pan-European banks would be able to spread country-specific risks over the currency union as a whole, thereby helping to break the link between national developments and domestic financial stability.

Looking at the potential obstacles to global financial integration that I mentioned before, it is a fact that the European Union has been able to remove a number of them within its perimeter. In particular, while still incomplete, a single rule book has been developed, embedding not only a homogeneous implementation of the international standards but also a suite of common complementary rules, affecting most relevant aspects of the regulated financial market activities. Moreover, within the banking union, the existence of single supervisory and resolution authorities provides for consistent policy approaches for both crisis prevention and crisis management.

Yet it seems that regulatory harmonisation and the creation of the banking union have not yet delivered substantive results in terms of banking integration. In particular, the volume of cross-border loans or deposits within the euro area, the penetration of foreign banks in domestic jurisdictions and the number of cross-border merger and acquisition operations in the banking industry have not increased much since the creation of the banking union[6].

One explanation which has often been put forward is that there are not sufficient incentives for banking integration. In particular, authorities within the euro area can still impose specific capital, loss absorption and liquidity requirements on subsidiaries of pan-European firms beyond the obligations imposed at the group consolidated level. In other words, even after the recent review of relevant European Directives and Regulations,[7] the legislation still permits the ring-fencing of local subsidiaries of European banks even within the banking union.

Ring-fencing of local subsidiaries could be seen as fundamentally inconsistent with a fully functioning banking union[8].At the same time, it could also be a natural consequence of the still limited degree of financial integration within the euro area and the insufficiency of the existing risk-sharing mechanisms.

Logically, progress in deepening the economic and monetary union and completing the banking union would strengthen the case for a full transfer of financial stability responsibilities to EU authorities. More specifically, the availability of a common (fully mutualised) deposit guarantee scheme - in addition to the existing Single Resolution Fund - would provide arguments for reducing the current ring-fencing possibilities for the local subsidiaries of pan-European groups.

In the European Banking Union, achieving such integration and removing ring-fencing is even more relevant than at the global level, and it also looks more feasible. For instance, together with local authorities, both the ECB and the Single Resolution Board are already involved - though in different ways - in defining the requirements for banks' liquidity, capital and loss-absorbing capacity at both the consolidated and the subsidiary level. Moreover, the enforceability of intragroup guarantees aimed at ensuring the transfer of resources from the parent company to subsidiaries in case of need looks somewhat less uncertain for legal entities operating under EU law than among firms incorporated in completely different jurisdictions. That could reduce the need to pre-position large amounts of resources with the subsidiaries and help to achieve a balanced allocation of resources within pan-European groups that would mitigate the potential impact of ring-fencing practices on the integration of the European banking industry.

4. Concluding remarks

I am fully aware that this is much easier said than done. Moreover, regulation is never the only cause, and often not the most relevant cause, of market fragmentation.

As is the case in other parts of the world, the banking sector in Europe faces challenges that can constitute structural obstacles for additional integration. For example, the persistently low level of profitability - most likely associated with the industry's excess capacity - does not favour the cross-border expansion of European banks but, more naturally, additional within-border consolidations seeking economies of scale.

In addition, the disruption posed by technological developments is generating uncertainty as to the industry's prospects and the sustainability of some traditional business models. That uncertainty - to a significant extent already reflected in banks' equity prices - does not help commercial banks' development of expansionary corporate strategies through regular mergers with, or acquisitions of, other traditional financial institutions located in foreign jurisdictions.

However, it is likely that over time technology will further increase the availability of all types of financial services on a remote basis, which could foster greater integration of the financial industry at both the global and the European level without requiring the physical presence of foreign players in the different domestic markets. That would in no way eliminate the need for deep regulatory reflection, but, arguably, it would have a completely different tone. In my remarks, I have discussed cross-country cooperation as a desirable development to enable regulation to achieve a better social return by promoting more financial integration. In the future, what now looks desirable may become essential. In a context of de facto integration linked to blurring borders in the provision of financial services, close international cooperation will become an essential element of any regulatory framework aiming to protect the integrity and stability of the financial system.

Thank you. ■

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[1] See Financial Stability Board, FSB report on market fragmentation, June 2019.

[2] See Financial Stability Board, Guiding principles on the internal total loss-absorbing capacity of G-SIBs ('internal TLAC'), July 2017.

[3] See eg. W. Ervin, «Ring-fencing: escape from the prisoner's dilemma», Banking Perspectives, third quarter 2018; and F. Villeroy de Galhau, «How to develop a financial Eurosystem post-Brexit», speech at the Eurofi High Level Seminar in Bucharest, April 2019.

[4] Financial Stability Board, FSB report on market fragmentation, June 2019.

[5] International Organization of Securities Commissions, Market fragmentation and cross-border regulation, June 2019.

[6] See F. Restoy, «The European banking union: achievements and challenges», EURO Yearbook 2018 - completing monetary union to forge a different world, IE Business School, February 2019, pp 215-33.

[7] See European Commission, Adoption of the banking package: revised rules on capital requirements (CRR II/CRD V) and resolution (BRRD/SRM), April 2019.

[8] See M. Draghi, «The benefits of European supervision», speech at the ACPR Conference on Financial Supervision, Paris, 18 September 2018.