GLOBAL FRAGMENTATION

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Global financial fragmentation: can progress be made?

Financial market fragmentation is a significant challenge for regulatory authorities and policy-makers. The challenge is between ensuring and promoting financial integration on the one hand and preventing contagion and maintaining financial stability on the other. Fragmentation in financial markets can have detrimental effects such as less competition, higher costs of capital, and reduced availability of services. However, as noted for example by the FSB in its Report on Market Fragmentation, some types of market fragmentation are justified and legitimate, and are inevitable consequences of measures taken to safeguard financial stability[1].

Indeed, fragmentation can be an inevitable result of the fact that jurisdictions across the world must retain an appropriate degree of control over risks to their financial stability, even if they also wish to exploit the opportunities deriving from international integration.

The Covid-19 crisis has put the global economy under extraordinary stress. However, a remarkable feature of the crisis has been how rapid and coordinated public policy responses to support the economy, including the financial sector, have largely averted fragmentation in the global financial system. This has confirmed the economic rationale for policy coordination at the international level.

Regulators and supervisors have coordinated their response via the various fora and bodies that had been set up in the aftermath of the global financial crisis. They have also learned from one another in designing and implementing their respective measures. Going forward, it will be equally important to coordinate exit strategies from public support measures so as to avoid possible fragmentation from this source and maintain a level playing field for healthy competition among the major jurisdictions.

Multilateralism, when there is a common will, remains the most efficient way to finding solutions to common issues affecting our global economy.

The EU takes concerns about market fragmentation seriously. The EU financial sector entered the Covid-19 crisis from a position of strength, due to the regulatory reforms introduced after the global financial crisis and to the sector's own efforts to overhaul business models and build resilience. The financial sector is "part of the solution" to this crisis. Nevertheless, the EU has responded to the crisis with a set of measures to support the financial sector, notably actions taken by the European Central Bank to facilitate bank lending and ease pressure on financial markets and a series of legislative and regulatory measures brought forward by the Commission and supervisory authorities.

These measures complement the wider policy response reflected in the €750 bn recovery effort, Next Generation EU (NGEU), and major fiscal support measures in the Member States. The EU has also intensified its efforts to complete the Banking Union and the new CMU Action Plan will result in deeper and more integrated capital markets. On the other hand, while the EU is committed to a more resilient and open global economy, it must also reinforce its open strategic autonomy in financial services as well as its capacity to protect the EU's financial stability.

While there is no "one-size-fits-all" approach to finding the appropriate balance between financial integration and financial stability, equivalence is a key tool in this regard. Equivalence decisions in financial services are mutually beneficial for the EU and for third-countries, and serve the EU's objective to promote the international integration of financial markets while preserving financial stability. By narrowing cross-border divergences and incompatibilities, equivalence reduces global market fragmentation and enhances the EU's regulatory and supervisory cooperation with third-country authorities in a sustainable way.

Multilateralism, when there is a common will, remains the most efficient way to finding common solutions to common issues affecting our global economy. In the financial sector, convergence towards international standards helps all jurisdictions to ensure that similar risks can be addressed in a similar way and that races to the bottom - prone to creating financial instability and contagion risks in global markets - are avoided.

1. https://www.fsb.org/wp-content/uploads/P040619-2.pdf

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Why non-financial reporting matters

Europe needs sustainable, environmentally-friendly growth, and the EU's Green Deal promises to deliver the green transformation that society needs – while at the same time supporting an inclusive economic growth.

The UN Sustainable Development Goals provide the target society is aiming for. A key component of reaching this target will be measuring companies' sustainability practices. Environmental, social and governance factors relevant to sustainable value creation are increasingly material to business performance. Investors, regulators and other stakeholders all want to know how companies perform in these areas.

However, for an accurate measurement of long-term sustainable value creation, there needs to be a single framework integrating all ESG reporting metrics. Today, companies face challenges in measuring and reporting on their long-term value creation in a consistent manner at international level – the various ESG metrics and frameworks hinder companies from demonstrating value creation in a comparable and meaningful way.

Bank of America fully supports the work of the World Economic Forum's International Business Council (IBC) on a common core set of metrics to standardise ESG reporting. The IBC, chaired by our CEO Brian Moynihan, along with the Big Four and in collaboration with all stakeholders, built on the wide range of existing standards – such as TCFD, GRI, and SASB – and identified those ESG factors material to business performance. The IBC's "Stakeholder Capitalism Metrics" provides a core and expanded set of metrics that will lead to greater consistency, comparability and compatibility with the existing sector-specific approach and will serve as one of the building blocks for a global standard.

These metrics are NOT a new ESG standard in themselves, but rather a foundational set of existing metrics and disclosures deemed most critical for sustainable value creation – distilled together to help deliver a new kind of corporate leadership.

The EU is also reviewing its own rules for non-financial reporting, as part of its Green Agenda to progress towards the disclosure of more meaningful and comparable data to support financial decisions. We would suggest that such work at EU level should be informed by and build on already existing and verified standards.

The time has come to establish a single sustainability standard-setter.

Looking more widely, we recommend that standards on non-financial reporting should be established at international level, as achieving the UN SDG goals must be a global ambition. Moreover, any standards should converge towards the development of a systemic global solution – similar, for example, to international accounting standards.

Ideally in our view, a reporting standard should cover the entire range of ESG reporting, including the broader range of environmental factors. The metrics will need some uniform characteristics. They will need to be industry and business model agnostic, while remaining relevant and material to each; they will need to be measurable, verifiable and comparable across firms; and they will need to describe the connection between sustainability and longer-term financial results. For this purpose, we propose that any new standard follows the IBC's four pillars that are aligned with the SDGs and principal ESG domains: Principles of Governance, Planet, People and Prosperity. Metrics like Sustainability reporting should be developed with the same level of governance and controls that support financial reporting and hence be auditable. It is not an easy task and will require some imagination and creativity.

The time has therefore come for all parties, including companies, investors, regulators, and governments to work together to achieve these ends and establish a single sustainability standard-setter. This should be independent and properly funded, with broad stakeholder composition and the requisite expertise at both the board and staff levels, to address the full suite of ESG reporting. We support the IFRS Foundation in leading the discussions on developing a global sustainability reporting standard.

To address the challenge of climate change, ambitious international solutions are called for. An internationally-accepted common reporting framework embedding non-financial and financial considerations will lead to a better allocation of capital – and in turn will help address one of humanity's most pressing challenges.

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More international coordination today to improve financial system resilience tomorrow

Following decades of global financial integration, we have begun to see some retrenchment, as evidenced by declining euro area portfolio investment flows since their peak in 2016. With global flows being reshaped as a result of geopolitical tensions, we have also seen continued financial fragmentation within Europe – not just as a result of Brexit but also due to continuing frictions between home and host countries.

The trend towards financial fragmentation has been aggravated further by COVID-19. While the banking industry appreciates the bold and swift policy reactions to the pandemic, the supervisory response to common issues brought about by the crisis appeared somewhat disjointed, with capital and liquidity relief measures diverging significantly across major jurisdictions.

An inward-looking focus may unfortunately undermine the encouraging progress in financial integration made since the 2008/09 financial crisis. Over time, this could negatively impact the pricing and availability of financial services within the EU.

The lack of consensus around the finalisation of the Too-Big-To-Fail (TBTF) reforms illustrates the scale of the challenge we now face. The industry has made great progress in terms of self-sufficiency (financial, processes and governance) within individual entities – around USD 300bn of TLAC built up globally in the first half of 2020 alone. Yet the global implementation of agreed reforms – highlighted by the FSB itself – remains uneven in important areas. These include cross-border coordination and allocation of internal TLAC, while open issues remain to be addressed consistently through closer regulatory cooperation, avoiding uncoordinated measures across host jurisdictions.

To direct capital towards facilitating the transition to net zero carbon emissions, internationally harmonised definitions and rules are essential.

Open issues include 'funding in resolution' and ensuring a robust framework for the increasingly significant activity related to non-bank financial intermediation, where lessons need to be drawn from the market liquidity issues experienced in March 2020. 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.

Together with other measures outlined below, this should encourage in particular host authorities to limit excessive pre-positioning requirements, as intended by the FSB in designing the TLAC framework. As a consequence, the increase in costs for banks, which would over time feed through to the economy, would be limited. Clearly this is important to support the recovery.

Moreover, there are several actions which could be taken to foster further international integration to the benefit of each individual country, given the global financial system remains highly interconnected, reflecting both supply and demand needs across jurisdictions.

First, authorities need to follow through consistently on the reforms already started, such as completion of the Banking Union, the TBTF reforms and consistent implementation of Basel 3. It's also key to step up efforts to remove existing impediments to cross-border consolidation, which is the best route to attain financial integration.

Furthermore, regulatory cooperation will continue to be critical to address the global challenges posed by climate-related financial risks, cyber risk and operational resilience, the digitalisation of finance and financial crime / AML, to name just a few. Ideally this should be moderated by global fora such as the BCBS, the FSB and IOSCO and potentially broadened even further to a wide range of public authorities and stakeholders due to the cross-sectoral nature of many of these issues. We will otherwise risk ending up with a scattered landscape of rules across major jurisdictions for an additional range of highly critical topics which are, by their nature, global.

Taking sustainable finance as an example, global principles would fill a key gap, enabling regulation focused on disclosure, climate risk measurement and taxonomy to become clear, actionable and truly purposeful. The inflow rate for sustainable investing funds by the third quarter of 2020 amounted to 36% year-on-year in an otherwise fairly static fund market.

If we want to unleash the full potential of private investors to direct the flow of capital towards facilitating the transition to net zero carbon emissions, internationally harmonised definitions and rules are essential.

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Drive globally balanced sustainability through regulatory coordination

In response to the Covid-19 pandemic, fiscal relief policies have been introduced to a greater extent in developed economies, notably in the EU and the US, than emerging markets. Consequently, revenues in these markets are more at risk of any economic downturn in the aftermath of the pandemic. The divergence in national responses has exacerbated existing regulatory fragmentation and its impact will remain even when Covid-19 subsides, but conversely the Covid recovery presents a real opportunity to re-orient capital flows towards sustainable investment.

Europe is the world leader in the burgeoning frontier of ESG reform and we fully support the EU's Renewed Sustainable Finance Strategy. Regulation aims to bring certainty to an arena where there is rapid change, considerable financial and legal risk, and a keen focus on organisational governance. These regulations should be harmonised globally as far as possible, to attract investors from around the world and, to this end, the EU's International Platform for Sustainable Finance (of which Japan is a member) will have an important coordination role. Regulatory harmonisation is critical for a common understanding of the rules and how various activities are categorised from an ESG perspective.

However, regulatory harmonisation should be balanced against ensuring that the rules appropriately consider the varying economic circumstances, energy needs, infrastructure constraints and cultures of different jurisdictions and industry sectors. This means focusing on high level global standards, rather than detailed prescriptive rules, particularly early on when there will be material disagreement amongst market participants on the minutiae.

We note that sustainability-linked bonds have been eligible for the ECB's Asset Purchase Programme since January and further initiatives are under consideration to achieve the objectives of the European Green Deal. We appreciate the need to gather momentum towards a carbon neutral economy and support the Commission's drive for a long-term attitude towards transition, noting the risks of "greenwashing" amongst market participants in order to meet certain targets or take advantage of applicable funding schemes.

The mission for banks and policy makers is to support clients' sustainable finance transition pathways with appropriate liquidity provision...

Policies that reward short-term actions may result in a pricing gap based on an entity's transition status, harming its access to funding and consequentially its ability to transition, and ultimately the economy as a whole. This is vital for enterprises with high climate change risks globally, where transition requires a huge amount of investment. The mission for banks and policy makers is to support clients' sustainable finance transition pathways with appropriate liquidity provision, recognising that there should be a proportionate application of regulations dependent on the client's circumstances.

In respect of Brexit, the envisaged memorandum of understanding covering financial services should provide a platform for EU-UK cooperation on regulatory standards to mitigate the effect of overlapping and inconsistent rules. An immediate concern for firms is how to find and interpret the law post-Brexit, due to the complexities introduced by the tangled web of statutory instruments promulgated as a result of the onshoring regime and the piecemeal temporary waivers set up to delay the anticipated "cliff-edge" effects.

Further regulatory divergence may also affect the competitiveness of the European financial market, with the average cost-to-income ratio of European banks being higher than that of US or Asian banks. This crucially affects third country banks operating in Europe, who may look to allocate capital elsewhere if their EMEA business is not sufficient to maintain sustainable growth. In addition to the increased cost that regulatory fragmentation brings for financial institutions, a key point that is often overlooked is the consequent impact for clients through direct cost increases, poorer service quality and more limited choice.

We urge policy makers to move towards global regulatory harmonisation and to 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.