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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.

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.

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