Global financial and regulatory fragmentation

Introduction

Financial fragmentation is unavoidable at the global in certain areas, but the real economy relies on a well-functioning financial system. It is therefore important that fragmentation is minimised. The first round of this discussion shows that financial fragmentation across the world is increasing, explores the reasons for this evolution and focused on its negative consequences. The session is then dedicated to solutions to address this key concern and the essential role of supranational institutions in this respect.

1. Financial fragmentation is increasing and has many negative impacts

1.1 The policy areas lack common structuring frameworks

An industry representative noted that the lack of common structuring frameworks is evident in the areas of sustainability and new technologies, where policymakers are regulating the space without the coordination previously seen in policy discussions, such as cross-border payments and banking resilience. This becomes problematic in the area of sustainability due to overlapping and contradictory requirements across jurisdictions, which risks hampering the rapid scaling of sustainable investment and channelling of capital to where it is most needed. The increasing reliance on extraterritorial clauses in certain jurisdictions can also create a potential conflict of rules.

In the area of new technologies, there have been a proliferation of different regimes, which differ by taxonomy, focus and timing. This does not make for a level playing field and increases the potential for regulatory arbitrage. In parallel, there has been the emergence of uncoordinated national restrictions on the cross-border flow of data risk, which impacts the capacity of regulated firms to deliver consistent services. This potentially inhibits the creation of an open environment that can fuel innovation.

In the current complex geopolitical environment, there is an additional concern that this trend could accelerate due to competition across different financial centres. Prudential regulation, sustainability, new technologies and increasing regulations in data will be impacted.

An industry representative agreed that sustainability regulation and reporting requirements is highly fragmented due to the implementation of frameworks by jurisdictions in advance of agreement on an international standard. This has reduced the positive impact of environmental, social and governance (ESG) frameworks as financial markets are less efficient at pricing climate related risks and opportunities, while firms operating globally face significant complexities and costs. It is important that the reporting standards now approved by the International Sustainability Standards Board (ISSB) are applied consistently in order to reduce fragmentation.

Another example of fragmentation is the implementation of Basel III. We continue to observe inconsistencies in implementation, such as the approach to risk-weighting unrated corporates. This is results in an uneven playing field and decreased comparability of capital ratios across banks, to the detriment of investors, while increasing operational cost and complexity for international banks.

Fragmentation can negatively impact the banking system's overall resilience, whether because certain risks are unaddressed, or due to harmful regulatory arbitrage, including where jurisdictions decide to go over and above international standards.

An official observed that there are parts of the sector in which it is not always the big jurisdictions that matter. In some areas such as crypto, some of the most important jurisdictions are relatively small. Jurisdictions will need to compare their regulations and decide whether they are similar enough in outcomes for cross-border business to take place.

1.2 Financial fragmentation is the result of many factors

An industry representative stated that there is currently an increase in financial fragmentation and regulatory divergence across the world, partly driven by challenging geopolitical and macroeconomic contexts. Regulatory divergence can be the result of many factors, such as different national financial systems, different policy choices by governments, diverse supervisory approaches taken by authorities in their local jurisdictions, and different local legal structures. Some regulatory divergence is inevitable, and arguably desirable, given specific local conditions. The fundamental question is where fragmentation is inevitable, and where it can be minimised.

An official commented that the fragmentation in recent years is not surprising. After the global financial crisis, various things were brought into regulation that had not been regulated before. There will never be identical rules in any given jurisdiction due to different political processes and ways of rulemaking.

However, most jurisdictions are active users and active participants in multinational fora. From a UK perspective, these fora are the right vehicles to reach a common consensus on what to achieve and solve through regulation and regulatory change. The way to ensure we reach interoperability of implementation is via bilateral government-to-government regulatory dialogues which our independent regulators also participate in.

1.3 The negative impacts of financial fragmentation

1.3.1 The negative consequences weigh on the ability of multi-jurisdiction financial firms to provide efficient financial services to the economy

An industry representative explained that unwarranted cross-border regulatory divergence remains a key concern, as this can create financial and operational inefficiencies. This can lead to inhibition of cross-border capital or trade flows, additional cost for consumers, and lower financial resilience as diverging rules impact the ability to move resources when needed during times of stress. This can also lead to increased compliance, legal and reputational risk.

1.3.2 Increased financial fragmentation leads to further risk

An industry representative commented that financial regulatory fragmentation has increased and is a critical issue, particularly for the international banks. For example, a Japan-headquartered bank that operates in the EU through a subsidiary must be compliant with the rules of the EU, UK, US and Japan. Japan is now implementing Basel III on 31 March 2024, in full alignment with the Basel Agreement. The EU is now aiming for January 2025, and the UK and US are aiming for July 2025, and they have not fully finalised their implementation. This fragmentation impacts not only financial institutions, but also corporate clients in the private sector.

Each jurisdiction has its own direct domestic issues, and fragmentation will lead to further risk. The Capital Requirements Directive VI (CRD VI) is finalising its language for third-country branches, which will further restrict activity in the region.

From the perspective of the international banks serving multinational companies, regulatory harmonisation is the key to providing a quality service for European clients which need fair access to the open market, and diversification of their capital and liquidity.

1.3.3 Financial fragmentation has negative impacts on growth and jobs

An official stated that jurisdictions need to understand that fragmentation is a cost that will ultimately be borne by the real economy. This sector will absorb the costs and pass them on, which is bad for economies, jobs and growth. In following this principle, it will become important for jurisdictions to avoid duplicative and conflicting requirements.

2. Promoting greater regulatory coherence at the global level should deliver more efficient markets and lower risks to financial stability

2.1 Ensuring common structuring frameworks at the global level is more important than ever

An industry representative stated that today's major regulatory challenges are global and interconnected. Large international banks have to navigate this interconnection among the various jurisdictions. There is a strong awareness and shared interest in sound, competitive financial systems, and close cross-border work. The recommendations are no different to those that have been expressed in terms of strengthening international cooperation through appropriate bodies, interoperability across regimes, and reliance on regulatory tools to encourage comparability and consistency. In the discussion on strengthening international cooperation and a common framework, there is a focus on timelines, as seen through the Basel III implementation.

The Financial Stability Board (FSB)'s 2023 global regulatory framework for crypto-asset activities is based on the principle of same activity, same risk and same regulation, and it attempts to provide that regulatory baseline. The ISSB's global baseline for sustainability disclosures and its endorsement by the International Organization of Securities Commissions (IOSCO) is also welcome. Expanding the standard-setting exercise to new emerging areas, particularly in digital and sustainability, is desirable.

In terms of interoperability, the key is for local regulators to continuously review the broader impact of their regimes to ensure that local requirements are consistent and interoperable with global initiatives. This way, regulatory frameworks can communicate globally, despite those local specificities which are inevitable. This will help reduce hurdles and the cost of fragmentation in the absence of a high degree of rule harmonisation.

Greater comparability of local regulatory regimes should be encouraged through mutual recognition agreements and equivalence mechanisms.

An industry representative noted that each jurisdiction has to be protected and has its own uniqueness. However, some banks which conduct international operations desire a level field in which to compete. The gaps should continue to be monitored and efforts should be made to harmonise them.

2.2 Aligning AML, KYC and financial crime in a consistent way

An industry representative suggested that fragmentation is essentially linked to deglobalisation: financial markets are a reflection of what is happening at a global level. There is a strong effort within the financial industry to try to achieve coherence within the important areas, particularly prudential rules. Successive waves of sanctions have shown that sanctions authorities are becoming increasingly aligned. There will always be fragmentation, but the most important areas for convergence should be identified in line with the priorities of the international bodies, as new rules are formulated in response to the US regional banks crisis and the Credit Suisse rescue, alongside new developments such as on virtual assets, ESG, and non-bank financial intermediation (NBFI). Avoidance of fragmentation also depends on whether there is discipline in aligned implementation across key jurisdictions.

Basel III should be implemented in a timely and consistent way. The focus will be on ensuring strong

financial resilience and market integrity and upholding investor protection.

Developments such as advanced technology and data protection are not agnostic to the financial industry. Ideally there would be a single law, but this is not possible. The focus will be to ensure that services are offered to clients across countries in the most efficient way.

UBS and Credit Suisse operate in more than 50 countries. To merge the group entity of Credit Suisse into UBS AG, approval needed to be sought from more than 150 authorities in over 50 jurisdictions. This is an example of fragmentation due to international licensing, and there is often more than one licence per country. This is the cost of doing business, and thus it is important to be clear about the business that it is intended to undertake.

Solvency and overall financial stability should be harmonised as much as possible to help efficiency in global financial markets and trade flows. On the conduct side, there will always be an element of national discretion. In terms of financial crime prevention and investor protection, there is a need for greater alignment. The Financial Action Task Force (FATF) does a good job in terms of reviewing countries.

2.3 Supranational organisations have an important role to play in ensuring interoperability in regulations for third-party risk management

2.3.1 Delivering interoperability in regulations for third-party risk management

An industry representative explained that Amazon Web Services (AWS) is the world's most comprehensive and broadly adopted cloud. AWS offers over 200 fully featured services across a number of different industries, including financial services. Regulation is increasing in third-party risk management, but whether it is fragmented remains uncertain.

In the EU, the Digital Operational Resilience Act (DORA) will establish a category of critical third-party providers (CTPPs) from 17 January 2025. In the UK, the critical third party (CTP) regime will bring direct obligations on third parties from early 2025. The European region is close to finalising formal regimes for third-party oversight, but there are many initiatives in other jurisdictions including Singapore, Japan, India and the US.

The principles of DORA and the UK CTP regime are similar in identifying CTPs or CTPPs that might impact the stability of the financial sector, and then identifying and understanding those material service providers. AWS expects to be part of these new regimes. Whereas DORA has a detailed compliance approach, the UK CTP regime has an outcomes-based approach and leverages self-assessment. AWS is working to ensure it meets the regulatory obligations of both regimes internally.

There is a real opportunity for interoperability and coordination. This will support the many customers in the financial services sector who choose to use cloud for the operational resilience, security and other advantages in the use of third parties. The supranational bodies, such as the FSB, the Basel Committee on Banking Supervision (BCBS) and IOSCO will be key in this, but regulators will also need to meet the specificities of their own jurisdictions.

AWS provides its services on an industry- and location-agnostic basis. There have been measures from regulators that may impact this model, such as the European Cybersecurity Certification Scheme for Cloud Services (EUCS), but a mandate does not currently exist. Such a mandate would negate the benefits of having an international and cross-border operable cloud service.

2.3.2 The role of international standard-setters

An industry representative stated that AWS wants to see the establishment of an internationally consistent, proportionate and risk-based approach to third-party risk management. Multilateral fora can help put together some of those principles to operate.

The FSB published a third-party risk management oversight toolkit last year. BCBS is reviewing its guidelines for outsourcing in financial services which were initially been published in 2006, and the operational resilience taskforce within the International Association of Insurance Supervisors (IAIS) is also working on this.

Ensuring that all stakeholders have a role to play is important, and not just policymakers, financial institutions or potential third parties, but customers and consumers. It is in nobody's interest to operate within a bubble. At Amazon more widely, there is a leadership principle to say that success and scale brings broad responsibility. There is a role to play as an active participant via supporting dialogues such as Eurofi, but also more formal dialogues such as stakeholder groups and consultations.

2.4 Global regulatory standards should be simplified and more rapidly implemented

An industry representative emphasized that regulation usually reflects good intentions, but the overall process can become highly complex, which increases cost. An outcomes-based focus is essential, avoiding complexity and aiming to fix what's necessary in a timely way.

The purpose of virtual assets is to democratise the financial system globally in an unregulated world. This is reliant on trust, and trust will be brought about by regulation.

Part of the complexity in the process is that regulation takes too much time to implement. There needs to be a sound framework, but at the same time it should cover both regulated and non-regulated parties. This is true for virtual assets and ESG, where there is much delegation to the unregulated parties. The industry needs to constructively contribute and take an outcomes-based approach.

On financial instability, there are many open questions across stakeholders on whether too-big-to-fail works. There is divergence between the experts claiming it works and politicians which do not have confidence that it does, partly due to the use of technical jargon.

2.5 IOSCO sustains its efforts on promoting regulatory cooperation and effectiveness at the global level

The IOSCO Board Chair stated that IOSCO is a community of national supervisors across 130 jurisdictions, whose

members are in various capacity in charge for the supervision of 95% of the global financial sector. Whenever it has capacity for consensus, IOSCO becomes a powerful influence as it presents a strong message for political decision-makers in those 130 jurisdictions.

As example, IOSCO's is cooperating with the FSB, International Monetary Fund (IMF), World Bank and FATF to ensure the implementation of IOSCO's recommendation for the regulation of crypto and digital assets.

2.5.1 Addressing emerging risks arising from digital finance

The IOSCO Board Chair stressed that the laymen who play with Bitcoin do not know or care about international standard setting bodies, but they expect to be protected against market manipulation risks, and against fraud, which is the reason IOSCO decided to launch its journey on digital finance years ago. In 2023, IOSCO has been able to publish two toolkits with comprehensive policy recommendations for the regulation of Crypto and Digital Assets and for Decentralised Finance (DeFi).

A global approach was necessary as soon as possible as that is what people expect. The speed of its release should not be at the expense of safeguarding the quality of the decisions taken.

2.5.2 Implementing a global framework for sustainability disclosures

The IOSCO Board Chair explained that one of the key added values of IOSCO's work on sustainable finance is about the transparency and disclosures of non-financial information by corporates. Disclosures need to be useful to investors, to help them take investment decisions that are in-line with their ESG expectations. This will be a long journey and it will differ amongst the various jurisdictions. But what matters to me is that the train starts on time. Jurisdictions are subject to different realities, which they must take into account as they consider their journey. From IOSCO's perspective, we feel that interoperability between regimes is key to ensure the comparability of disclosures, but the process will take time to complete. Eventually, we expect that up to 130,000 companies will either apply, adopt or otherwise be informed by the ISSB standards. The work of IOSCO provides an answer to the risk of fragmentation.

2.6 Additional way forward

An official noted that the UK has recently signed a mutual recognition agreement with Switzerland with the idea of deference embedded into it. Deference is a concept that dates back to the financial crisis and is very possible to achieve, supported by robust assessments.

The UK also previously announced its decision to allow EU funds to continue to market from the European Economic Area (EEA) into the UK without any additional requirements, which is an example of genuine deference. One of the final hurdles will be on sustainability disclosures. There is a Financial Conduct Authority (FCA) labelling regime, and discussions need to continue on how similar the EU's regime will be. The ultimate objective will be that they are sufficiently similar to allow efficient cross-border business.