TACKLING MARKET FRAGMENTATION IN GLOBAL BANKING

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The Financial Stability Board (FSB) and International Organization of Securities Commissions (IOSCO) held a day-long roundtable on market fragmentation in financial services, preparatory to a report to the G20 Finance Ministers and Central Bank Governors meeting in June. This short note summarizes the points I raised as a panelist, focused on impediments to cross-border banking. The key elements are:

1 **Cross-border banking is important for society**

2 **There are at least 13 broad classes of impediments created by the public sector**

3 **We need to tackle this holistically, in addition to dealing with individual issues**

In my view, the G20 leaders should highlight the importance of tackling this issue and should mandate a body to begin a process of global consultation, leading to a new social compact on cross-border banking.

WHY DO WE WANT CROSS-BORDER BANKING TO WORK WELL?

Cross-border banking, whether within regions or globally, brings many important benefits.

Efficient use of financial resources

The financial sector plays a crucial role in moving money from those who need to deploy it to those who can put it to best use. This benefits savers/investors, businesses and families building their futures, and society as a whole. Trapping money within national borders reduces opportunities for higher returns to investors and also means some worthy projects will not be funded. This inefficiency slows economic growth, hurting us all in indirect ways.

Diversification that increases financial stability

Economists have long recognized that diversification of investments reduces risk and we have seen the financial stability benefits of abolishing restrictions on cross-border banking within, for example, the United States.

Support for cross-border activity in the rest of the economy

Businesses and individuals increasingly cross borders in their daily activities, whether via the internet, through trade contracts, or physically. Banking must similarly cross borders in order to effectively support these activities. Despite some increasing trade barriers and greater nationalism, I do not believe anything will ultimately turn back the tide of globalization that is driven by improved technology of all kinds, whether in transportation or information technology. Banking must follow this same trend to remain fully relevant to its customers.

Reduction in inequality across nations

This globalization of the real economy has been a key to allowing literally billions of people around the world to grow out of poverty, reducing income differentials between the richest and poorest nations by bringing new opportunities to the poorest. Barriers to cross-border banking, such as the loss of correspondent banking relationships in some countries, make these business ties harder.

HOW DOES PUBLIC POLICY DISCOURAGE CROSS-BORDER BANKING?

Investors and bank executives increasingly question the rationale for involvement in cross-border banking and there has been a significant pullback. To see the contribution of the official sector to this, it is important to look at the totality of the impediments, not just individual items. The private sector creates some barriers as well, but this note focuses on the public sector's choices.

To be clear, I am not suggesting that all policies that create barriers to cross-border banking are therefore bad policies. With rare exceptions, they are put in place to further legitimate policy goals. The important thing is to recognize just how widespread these barriers are, so we can consider whether (a) policymakers have found the right overall balance of benefits and costs and (b) whether that balance could be achieved more efficiently through other means. My own view is that current policies, taken as a whole, create an unnecessary drag on the global economy, beyond the necessary costs to achieve our collective financial stability goals.

Not all countries or regions create all of these impediments, but the following 13 categories are widespread:

Outright prohibitions.

In some cases, cross-border banking transactions have simply been disallowed. An extreme case occurred during the European debt crisis, when a major Italian bank was forbidden by its host country from using deposits gathered by its branches in that nation to support lending through its branches in Italy, even though both nations were in the European Banking Union.

Ring-fencing and forced subsidiarization.

There are many examples of nations that require foreign banks to ring-fence or subsidiarize their operations in the host country, losing many efficiencies that are present when using branches. The UK has ring-fencing as a result of the Vickers Commission, the US requires large foreign banks to create Intermediate Holding Companies, and the EU is close to requiring Intermediate Parent Undertakings. Whatever their virtues, all of these create a less efficient use of capital, liquidity, and management time. Further, Wilson Ervin[1] and others have shown that ring-fencing capital on a national basis can decrease global financial stability by trapping excess capital in one country when it may be needed in another at a time of crisis.

1 Ervin, Wilson, "Understanding 'ring-fencing' and how it can make banking riskier," Brookings Institution, available at https://www.brookings.edu/research/understanding-ring-fencing-and-how-it-could-make-banking-riskier/

Capital requirements favoring domestic activity.

There are many ways that cross-border activity is treated less favorably in capital calculations. The most overt is the cross-border component of calculations of systemic importance that can trigger higher capital requirements. By explicitly treating cross-border activity as higher risk, without taking account of the nature of the activity, it clearly discourages such actions. There are also a number of more subtle ways in which supervisory choices on capital calculations can be biased towards domestic banks.

Liquidity requirements favoring domestic activity.

Quantitative liquidity requirements are newer, but there is clearly room for more favorable treatment of domestic activity than cross-border activity.

Resolution requirements favoring domestic activity and domestic entities.

As supervisors and resolution authorities increasingly demand detailed resolution and recovery planning, there is a great deal of room to discourage cross-border ties. This has been a major concern of Foreign Banking Organizations in the US, for example. In this area, the devil is in the details, especially given the subjective nature of many of the decisions the authorities have to make.

Data requirements favoring domestic activity.

This issue is growing in importance as Big Data and machine learning revolutionize aspects of banking while concerns about privacy rights grow in parallel. Policymakers around the world are in the early stages of determining how best to proceed in this area and there are many risks to cross-border activity. First, the profusion of different standards by itself makes it harder and more expensive to operate across borders. Second, there is a temptation for certain countries to require "data localization," which significantly reduces the ability to effectively employ data on activity that crosses borders. This is a risk for anti-money laundering programs, for example, if banks are unable to look for patterns that cross borders.

Impediments resulting from the need to understand and to meet many varied national rules.

Cross-border activity requires banks to meet the mandates of multiple national authorities. Failure to create global standards, or to apply them in the same ways, increases the costs and difficulties of meeting these multiple mandates.

Extra-territoriality that adds costs and risks and can limit activities.

The problem of multiple mandates is exacerbated when certain countries or regions apply their rules on a global basis. The US has historically been particularly prone to this, but it is hardly the only jurisdiction.

Financial crime rules that can be excessively onerous and excessively varied.

It is critical to combat financial crime, but nations sometimes either overreact or simply fail to coordinate with other countries to the extent needed. A few nations have been virtually cut off from the global financial system as a result of severe cutbacks in their correspondent banking relationships as global banks find it hard to justify these ties from a financial point of view, given the compliance costs and large reputational and regulatory risks.

Legal sanctions and regulatory fines that hit foreign banks harder.

There is a strong suspicion that domestic banks are treated more leniently when they violate rules or laws than foreign banks are. This is hard to prove, but is certainly a risk.
Even the perception serves as a barrier to cross-border activity.

Supervisory decisions that tend to favor local banks.

It is clearly the case that in some countries supervisors are significantly more favorable to domestic banks.

Unofficial support by national governments for "national champions."

In some countries, the bias goes further, with a strong, but unofficial, policy of trying to build up one or more of their banks as "national champions" that can take on the world. Foreign banks suffer by comparison.

Taxes.

Sometimes tax laws favor domestic banks over foreign ones. Most recently, the US instituted the base erosion and anti-abuse tax (BEAT) as part of its major changes to corporate taxation. Most likely unintentionally, some of its provisions are particularly costly for foreign banks given the strong ties between their US operations and their global activities, which create cross-border flows subject to the tax that have no counterpart for domestic banks.

WHAT CAN WE DO ABOUT THESE IMPEDIMENTS?

I strongly urge the global policymaking community to tackle this issue holistically as well as at the level of individual policies. There is a temptation to simply deal with this by looking at policies one by one, often in individual countries. This is indeed important, but as the list of impediments shows, there are many tools open to national authorities that choose to disadvantage cross-border activity. We need to find a way to step back and agree on an overall approach that will give authorities sufficient confidence in international cooperation that they will agree to pull back on the use of these barriers.

This is a multi-year, global undertaking at a time of "regulatory fatigue", but if we never begin to heal the trust issue at the heart of these policies and instead focus on symptoms, it is unlikely we will ever get to the right answers. Looked at more hopefully, there are multiple examples of analytically hard, and seemingly politically impossible, agreements that have eventually been consummated. The European Banking Union is a good example, as the policy community built a consensus on its need over a period of years and eventually a time of crisis changed the politics to make it not only feasible, but imperative.

The Japanese Presidency of the G20 is concerned about market fragmentation. It would be very helpful if the G20 leaders highlighted the need for this global effort and mandated an appropriate body to begin the process. I do not have a strong view of the best forum to advance this discussion. The Financial Stability Board and the Basel Committee on Banking Supervision (BCBS) are both logical candidates and perhaps there are other structures as well that would be sensible.

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