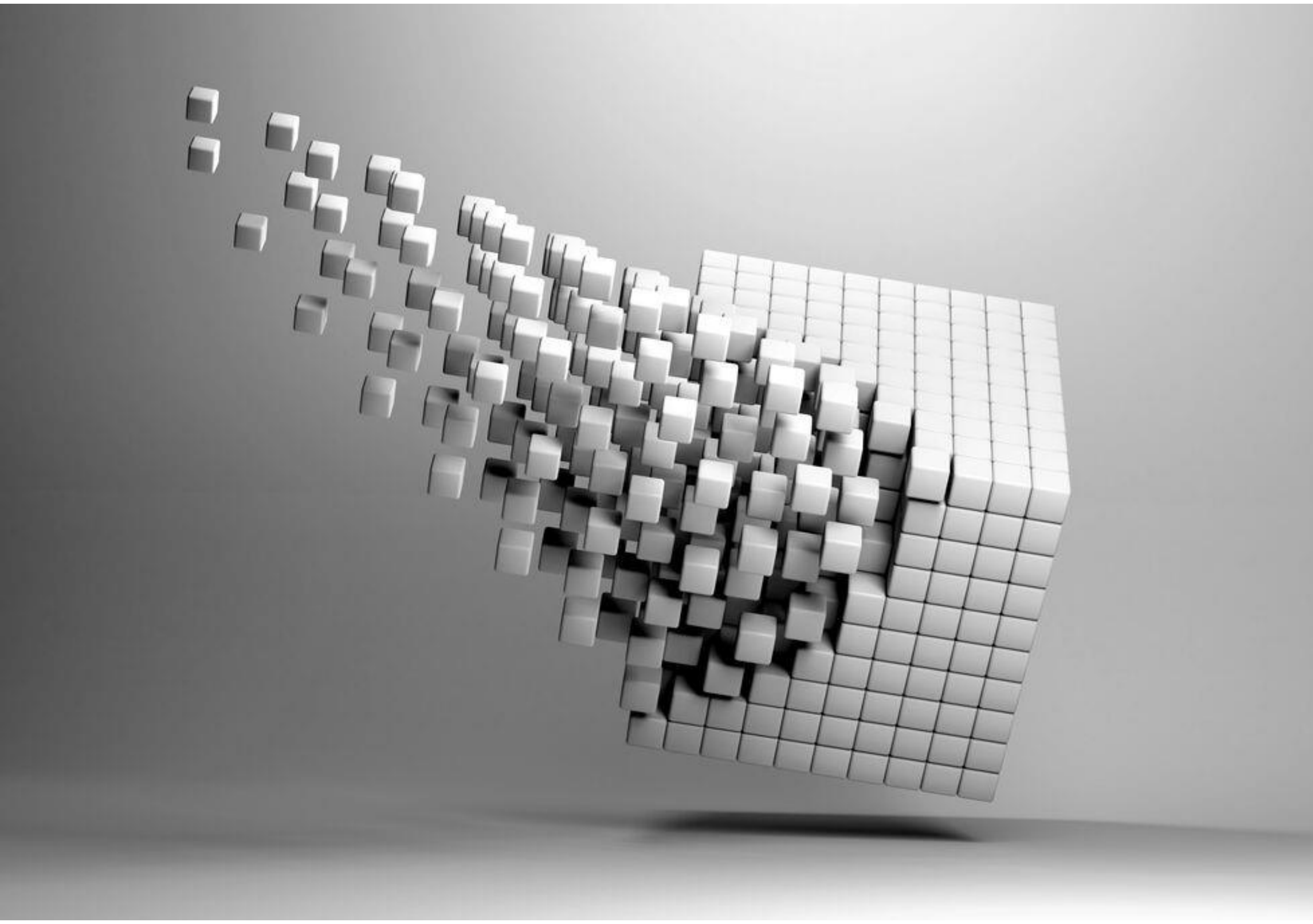
The Costs of Fragmentation and Possible Solutions

July 2025



A&O SHEARMAN

FRAGMENTATION REMAINS A PROBLEM

The Financial Stability Board (FSB) launched an important initiative in 2018 to explore ways to address the risk of market fragmentation, which the industry welcomed. This initiative, conducted in coordination with other standard setters, such as the International Organization of Securities Commissions (IOSCO), has been and continues to be critical. However, despite this, we continue to see a growing level of fragmentation, which could reverse many of the achievements made since the Great Financial Crisis.

Fragmentation can undermine the progress that has been made in rebuilding the resilience of the global financial system and may result in negative consequences for economic growth and competitiveness. It can increase regulatory arbitrage, disrupt the level playing field between banks and lead to an unintended shift of risk to less regulated parts of the market. Fragmentation also runs the risk of undermining the purpose and usefulness of the global standard-setting processes.

Fragmentation resulting from mis-calibration of global standards or excessive regulatory and supervisory divergence can trap capital, liquidity, and risk in local markets; create significant financial and operational inefficiencies resulting in additional unnecessary costs to end-users; reduce the capacity of financial firms to serve both domestic and international customers; and may increase fragility, making markets more brittle and less resilient.

KEY ASKS

The FSB and BCBS should re-evaluate the risks and issues identified in the FSB’s 2019 paper on fragmentation and report on initiatives taken or underway to address those issues including:

- A stocktake of policies that may lead to forced subsidiarisation and alternative policy tools available to achieve local objectives that do not lead to fragmentation.
- Ways to mitigate capital, liquidity, and resolution-related frag-mentation, given their negative impacts on the resiliency of the financial system.
- Jurisdictions with requirements that lead to ring-fencing of subsidiaries should be encouraged to undertake a review of whether these are fit for purpose and appropriately calibrated given implementation of the post-crisis resolution framework.
- Greater cooperation to increase financial stability and allow financial markets to function most effectively to support competition and the growth of the economy.
- The FSB should re-evaluate the functioning of annual supervisory colleges and case management groups, their purpose and whether that purpose is being met as well as it could be.
- International standard setters should consider how public and private sectors, and international and national bodies should work together to establish a policy cycle that reduces existing frag-mentation, builds on practical experience and eliminates future examples.

WHY ADDRESSING MARKET FRAGMENTATION IS IMPORTANT TO LOCAL AND GLOBAL ECONOMIES

Global capital markets are integral to enabling investors to serve the needs of end-users around the world. [1] Putting savings to work for maximum economic benefit requires policymakers to focus on eliminating unnecessary barriers. Financial sector oversight must not only ensure stability and resilience, but also encourage prudent risk-taking and value creation, and seek to avoid protectionist policies that frustrate economic investment needs and limit growth.

We welcome recent initiatives, such as the EU's savings and investments union, which seek to create more integrated capital markets that more effectively facilitate investments in strategic objectives, together with the increased priority given to simplification and growth agendas in numerous countries.[2] Redressing the frictions caused by fragmentation remains crucial for all countries wishing to maximise the efficiency and economic growth of their capital markets and can be done without compromising financial stability.

This paper follows our recent letter to the FSB, IOSCO and BCBS to re-prioritise addressing increasing fragmentation and home-host coordination. Looking at the perspective of globally active banks, the paper focuses first on the proliferation of localisation policies, a particular example of fragmentation which restricts a bank from efficiently managing risk and allocating capital within its group as, when and where needed during times of stress, and advocates specific mitigating solutions to such policies. It then moves on to examine and propose refinements to the processes and procedures of international standard setters more broadly, to reduce fragmentary policies or, at the very least, to identify, monitor and limit their impact.

WHAT IS FRAGMENTATION? ITS CAUSES AND CONSEQUENCES

In its 2019 report on Market Fragmentation & Cross-Border Regulation, IOSCO cited the Global Financial Markets Association's definition of fragmentation as "anything that impacts the free flow of resources or information relative to the unfettered supply and demand for those resources or information". [3]

Fragmentation is a multi-dimensional, complex and relative concept. There is a continuum between a unitary frictionless market on one end of the spectrum and fully compartmentalised and isolated markets on the other end of the spectrum. This continuum can be observed within a country, a region or globally, and each market can be placed somewhere on that continuum. Whilst multiple factors affect where financial markets stand on that continuum, financial regulation is a key determinant.

As the IOSCO paper highlights, fragmentation can have several causes including market-led practices, investor preferences or legislation or regulation. It is also accepted that not all fragmentation is undesirable.

The FSB, in its 2019 report on market fragmentation, states 'differences may reflect jurisdictions' differing stages in the economic or financial cycle, varying degrees of financial development, or differences in domestic market structures, customs and policy priorities.[4] As such, they may increase the resilience of domestic financial systems and reduce the

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1 https://www.msci.com/www/blog-posts/sizing-up-the-global%20market/05073690405#:~:text=MSCI's%20estimate%20of%20the%20global,prior%20(see%20exhibit%20below).
2 https://finance.ec.europa.eu/regulation-and-supervision/savings-and-investments-union_en
3 https://www.iosco.org/library/pubdocs/pdf/IOSCOPD629.pdf
4 https://www.fsb.org/2019/06/fsb-report-on-market-fragmentation-2/

transmission of stress or risks across borders and thus serve as firewalls.' However, in many cases regulatory fragmentation confers national benefits at significant costs to global financial stability and the global economy.

The International Monetary Fund (IMF) reports that the costs of geoeconomic fragmentation are likely to fall on trade, migration, capital flows, technology diffusion and the provision of global public goods.[5] A 2018 survey by the International Federation of Accountants and Business at the OECD estimated that a piecemeal approach to financial sector regulation costs the global economy $780 billion a year.[6] A World Economic Forum report published in January 2025 presents 'new analysis indicating that one-year economic output losses from fragmentation could range from $0.6 trillion to $5.7 trillion, or about 5% of current global gross domestic product (GDP) and twice the output losses caused by the COVID-19 pandemic, depending on the degree of fragmentation.[7] Similarly, inflation rises steadily in most countries as fragmentation increases, which is likely to necessitate higher interest rates and have an impact on borrowing costs for individuals, businesses and governments'.

All policy decisions involve trade-offs between the expected benefits and anticipated costs of the policy. For regulatory policy decisions, benefits will typically be considered in terms of societal and economic benefits derived from improved investor protection, market integrity or the resilience of market participants and the market. Costs will include direct costs to affected market participants, but also indirect costs – for example to end-users facing shallower and/or less competitive markets. Often costs result from unintended consequences of well-intentioned or appropriate for the time, local policy.

Regulatory fragmentation is detrimental to the market where there has been an incomplete cost-benefit analysis. Our proposal is to address this by recommending changes to the international policymaking cycle to improve appropriate early engagement in the development of standards. It seeks to ensure a better understanding and accommodation of national or regional specificities at the outset and, thereby, foster a more consistent implementation of international standards. It also seeks to ensure a more efficient and open review process, whereby market developments and feedback stemming from the implementation process flows back into a refinement and recalibration of such standards, as and when appropriate.

First, however, we consider a particular category of fragmentary policy – localisation policies. Issues around such policies are generally well understood and have been discussed at length but we have seen little improvement and indeed further examples. To that end, we make a number of specific technical asks.

LOCALISATION POLICIES CAUSE PARTICULAR HARM

We recognise the rationale for oversight of local operations. However, host jurisdiction regimes requiring local presences, which are subject to standalone requirements for ring-fenced capital, liquidity and non-financial resources impair competition and can jeopardise financial stability.

[5] https://www.imf.org/en/Publications/Staff-Discussion-Notes/Issues/2023/01/11/Geo-Economic-Fragmentation-and-the-Future-of-Multilateralism-527266
[6] https://www.ifac.org/knowledge-gateway/discussion/fragmented-financial-regulation-780-billion-tax-global-economy
[7] https://www.weforum.org/publications/navigating-global-financial-system-fragmentation/

This has been observed in fragmentary capital/liquidity ring-fencing policies, local supervisory measures decentralising financial and operational resources and governance and the application of standards designed for a global entity or parent company to their subsidiaries as well.

Research suggests that there is a material advantage for a host jurisdiction that ring-fences subsidiaries within its jurisdiction, so long as other jurisdictions do not match that decision.[8] This host jurisdiction benefits from both trapped local capital and the ability to access a large central reserve at the parent. However, actions of one jurisdiction to ring-fence can lead to a 'prisoner's dilemma', where each jurisdiction seeks to achieve a local benefit (more capital) but ends up worse off when others also pursue their own incentives (trapped capital). It is suggested that failure risk increases by a large multiple if ring-fencing becomes pervasive, potentially as much as five times or more, compared to a structure where internal capital is fully mobile.[9]

Dividing group capital and liquidity resources in various jurisdictions creates market uncertainty and exacerbates a global group's stress in times of turmoil. The problems with this were illustrated amongst the contributing factors to the failure and ultimate acquisition of Credit Suisse. FINMA, in its report on the lessons learned from that failure surmised that 'the repatriation of capital sourced from profits and surplus capital from subsidiaries proved difficult – due in part to an increase in local regulatory requirements abroad.[10] Profits accrued and factored in by the Group in consolidation could thus not be easily forwarded in good time to CS AG'.

We continue to welcome the FSB's investigation into legal, regulatory, and operational obstacles to cross-border funding in 2022 and echo its warning following its review into the events of March 2023 that such obstacles to mobilising collateral or liquidity across borders could impede an effective resolution.[11] Equally, we support the BCBS' conclusion, in its report on the 2023 market turmoil, that '[s]ince the distribution of resources could either alleviate local liquidity pressures or spread them throughout the group, it is necessary to closely monitor this aspect.'[12]

Home-host cooperation is key to mitigating the frictions to the prudent and efficient allocation of capital and liquidity where needed, when needed in the post-global financial crisis world where the framework and mechanisms for effectively resolving a failing bank now exist. Our suggested proposals for the policymaking cycle below should serve to continue to foster the trust and understanding necessary to support such cooperation. In addition, we advocate a number of specific asks in this area.

FIVE SPECIFIC ASKS, FIVE YEARS ON FROM THE INITIAL WORK ON FRAGMENTATION

The FSB and BCBS should re-evaluate the risks and issues identified in the FSB's 2019 paper on fragmentation and report on initiatives taken or underway to address those issues, including in the following areas:

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8 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3085649
9 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3085649
10 See p. 56-7 of https://www.finma.ch/en/~/media/finma/dokumente/dokumentencenter/myfinma/finma-publikationen/cs-bericht/20231219-finma-bericht-cs.pdf?sc_lang=en&hash=3F13A6D9398F2F55B90347A64E269F44
11 https://www.fsb.org/uploads/P151223.pdf
12 https://www.bis.org/bcbs/publ/d555.htm

Ask: The IMF, FSB and BCBS should take stock of policies that may lead to forced subsidiarisation in member jurisdictions and identify their impact on global financial stability and economic growth. The organisations should consider alternative policy tools available to achieve local objectives that do not lead to fragmentation. This survey should also consider bespoke restrictions on branches, some of which may deliver a similar functional effect to subsidiarisation. International standards should recognise the value of branch networks and discourage localisation and subsidiarisation where this can be avoided, or the misapplication of international standards to subsidiaries.

Ask: Jurisdictions with requirements that lead to ring-fencing of subsidiaries should be encouraged to undertake a review of whether these are fit for purpose and appropriately calibrated given implementation of the post-crisis resolution framework, which includes resolution planning and enhanced loss absorbency requirements. Jurisdictions should be encouraged to tailor requirements to reflect the fact that subsidiaries are part of a larger group that acts as a source of strength, has its own resolution plan and is subject to home country stress testing.

Ask: International standard setters, including IOSCO, the FSB Standing Committee on Supervisory and Regulatory Cooperation, BCBS Policy and Standards Group, and BCBS Supervisory Cooperation Group should jointly work together with the industry to look for ways to mitigate capital, liquidity, and resolution-related fragmentation, given their negative impacts on the resiliency of the financial system, especially in these times when multilateralism and international cooperation are challenged.

Ask: We recommend that authorities focus on greater cooperation which would increase financial stability significantly and allow financial markets to function most effectively to support competition and the growth of the economy. When local rules do not consider the benefits from and impact on global approaches at internationally active banks and the markets they support, they exacerbate risks to individual firms and their clients, the local economy, and global financial stability.

Ask: The FSB should re-evaluate the functioning of annual supervisory colleges and case management groups, their purpose and whether that purpose is being met as well as it could be. Home and host authorities need to align and cooperate in support of the agreed resolution strategy for the group. In particular, we encourage active dialogue between regulators to explore ways to minimise geographic compartmentalisation of TLAC within a banking group.

SPECIFIC ASKS TO IMPROVE THE OUTCOME OF INTERNATIONAL STANDARDS MORE BROADLY

We urge international standard setters to consider how public and private sectors, and international and national bodies should work together to establish a policy cycle that reduces existing fragmentation, builds on practical experience and eliminates future examples. We would encourage global standard setters to reflect upon the experiences of developing and implementing international standards to date, and consider improvements that could be made to the process. Our suggestions are set out in what we describe as a ‘policy cycle’ below.

The Policy Cycle:

Phase 1 - Rulemaking

When developing global standards, practitioner experiences (including through industry engagement) and any national specificities must be considered early and fully to generate policy outcomes based on genuine consensus that can be fully and faithfully implemented nationally. Such standards should set the baseline to achieve the relevant policy outcome rather than strive to be the gold standard and they must align with the growing focus on simplification, competition and growth. In particular, international standard setters' processes should ensure that:

- Projects are scoped carefully and a consensus gained on the policy objectives in advance.
- Stakeholder involvement is maintained throughout, with industry feedback on proposals summarised and made public.
- National/regional consultation is conducted in parallel, where possible, to maximise the effectiveness of industry engagement, surface any local specificities that need to be accommodated and facilitate a full consideration of the practical impacts and potential challenges before the standards are finalised.
- Permissible national discretions are clear and their impacts fully assessed in advance and mitigated as far as possible.
- Impact assessments, including costs/benefits analysis and how the measures affect growth and competition, are provided in all cases.
- Greater recognition of foreign regulatory regimes is encouraged through the development and incorporation of outcomes-focused recognition or deference criteria and processes.

Phase 2 – Monitoring

Peer review processes should ensure a more holistic understanding of local implementation. In assessing whether a jurisdiction has implemented the international standards, international standard setters should also take into account any additional local rules that may meet similar policy objectives and which may affect the application of the standards. Additionally, it is well understood that differences in timing and / or the extent of implementation of internationally agreed standards can cause competitive disadvantages, erode trust and cooperation and potentially trigger the imposition of extraterritorial requirements on firms from jurisdictions that have not yet implemented reforms. As such, the rationale for delays or deviations in implementation beyond those anticipated in phase 1 should be understood and trigger phase 3.

Phase 3 – Review/Amendment

To the extent that jurisdictions in implementing standards, or international standard setters in undertaking their peer reviews, identify any market developments or issues that support deviation from international agreements, this should feedback into a review of the standards and, where appropriate, amendments. The policy cycle needs to create the agility required to react and adapt when standards are no longer fit to address the policy objectives identified in phase 1.

To this end, we recommend that:

- Regulatory experience should be fed back into policy making and institutional change at both the national and international levels. Practical lessons learned and good practice should be reflected in good regulation and this positive feedback loop should be a feature of the ongoing monitoring of the effectiveness of policy and legislation (e.g., CMG experience should feed back into improvements to resolution standards, supervision and cooperation).
- To the extent that peer reviews of national implementation identify substantive divergence, the drivers for this should be fed back into policy making and a review of the relevant standards. Feedback from national transposition consultation processes should also be factored in.
- To the extent that implementation delays or processes identify market developments or information that was not known or properly understood when developing the standards, this should trigger a prompt review of the standards and whether they remain best calibrated to achieve their policy objectives.

Any proposed amendments should pass back into phase 1 of this proposed policy cycle and be subject to full appropriate engagement and assessment in order to result in a revised framework capable of consistent application by all member jurisdictions, where any necessary deviations for national specificities are fully understood when the revised standards are agreed.

The dynamic and evolving nature of global markets necessitates a regulatory framework that is both flexible and responsive. By incorporating a systematic feedback loop, fostering greater international cooperation, and continuously adapting standards to reflect new information and market developments, we can ensure that regulatory practices remain robust, proportionate, and effective. This commitment to continual improvement will not only safeguard market integrity but also promote a more resilient and cooperative international financial system, enabling growth and competitiveness. We stand ready to assist with these matters.

CONTACTS

Bank Policy Institute (BPI):

Samantha Riley
Head of International Regulatory Policy
Email: sam.riley@bpi.com

Global Financial Markets Association (GFMA):

Allison Parent
Executive Director
Email: aparent@global.gfma.org

Caroline Liesegang
Head of Capital and Risk Management, Sustainable Finance and Research
Email: caroline.liesegang@afme.eu

Carter McDowell
Managing Director
Associate General Counsel
Email: cmcdowell@sifma.org

Diana Parusheva
Managing Director – Public Policy and Sustainable Finance
Email: dparusheva@asifma.org

Institute of International Finance (IIF):

Martin Boer
General Manager and Chief Representative, Europe
Email: mboer@iif.com

Andrés Portilla
Managing Director, Regulatory Affairs
Email: aportilla@iif.com

A&O Shearman:

Bob Penn
Partner and Global Head of Regulatory
Email: bob.penn@aoshearman.com

Kirsty Taylor
Knowledge Counsel
Email: kirsty.taylor@aoshearman.com

ABOUT US

Bank Policy Institute (BPI)

The Bank Policy Institute is a nonpartisan public policy, research and advocacy group that represents universal banks, regional banks, and the major foreign banks doing business in the United States. The Institute produces academic research and analysis on regulatory and monetary policy topics, analyzes and comments on proposed regulations, and represents the financial services industry with respect to cybersecurity, fraud, and other information security issues.

Global Financial Markets Association (GFMA)

The GFMA represents the common interests of the world's leading financial and capital market participants, to provide a collective voice on matters that support global capital markets. We advocate on policies to address risks that have no borders, regional market developments that impact global capital markets, and policies that promote efficient cross-border capital flows, benefiting broader global economic growth. The Global Financial Markets Association ("GFMA") brings together three of the world's leading financial trade associations to address the increasingly important global regulatory agenda and to promote coordinated advocacy efforts. The Association for Financial Markets in Europe ("AFME") in London, Brussels and Frankfurt, the Asia Securities Industry & Financial Markets Association ("ASIFMA") in Hong Kong and Singapore, and the Securities Industry and Financial Markets Association ("SIFMA") in New York and Washington are, respectively, the European, Asian and North American members of GFMA.

Institute of International Finance (IIF)

The Institute of International Finance (IIF) is the global association of the financial industry, with about 400 members from more than 60 countries. The IIF provides its members with innovative research, unparalleled global advocacy, and access to leading industry events that leverage its influential network. Its mission is to support the financial industry in the prudent management of risks; to develop sound industry practices; and to advocate for regulatory, financial and economic policies that are in the broad interests of its members and foster global financial stability and sustainable economic growth. IIF members include commercial and investment banks, asset managers, insurance companies, professional services firms, exchanges, sovereign wealth funds, hedge funds, central banks and development banks.

A&O SHEARMAN