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## Executive Summary

The risk of fragmentation across financial markets has been recognized for several years. However, the problems created from excessive cross-border regulatory divergence - along with reversals in global integration and multilateralism - are continuing at pace. The costs of this policy direction weigh heavily on the real economy, impacting capital flows, trade, and inclusive access to financial intermediation.

As the focus by global policy makers on addressing these trends is more important than ever, the Institute of International Finance (IIF) outlines issues and recommendations to consider in order to avoid the negative economic consequences inherent in a fragmented global financial system.

## INTRODUCTION: Fragmentation as a Continuing Concern

Fragmentation is the result of many distinct policy choices and supervisory actions around the world which – while often with well-meaning intentions seeking to improve the security or uphold the sovereignty of any one jurisdiction – can potentially result in negative consequences for growth, security, competitiveness, and job creation.<sup>1</sup> At the same time, the trade-off between financial stability, investor protection, and market integrity on the one hand and fragmentation on the other is not approached by all jurisdictions in the same way, nor does it have the same impact on all market segments. Typically, fragmenting the interdealer and inter-banking market is likely to have consequences on systemic risk, by increasing the level of reliance between banks of the same jurisdiction. By contrast, fragmentation in the access to professional and retail clients may result in reduced competition between service providers and suboptimal pricing for clients but is unlikely to cause stability concerns.

When looked at holistically however, assessing and addressing the drivers and consequences of fragmentation overall has been a priority for both the international standard setting bodies and

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<sup>1</sup> For further information on the background to market fragmentation, please see: IIF 2019. "[Addressing Market Fragmentation: The Need for Enhanced Global Regulatory Cooperation](#)" January 24, 2019

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the financial services industry. In this regard, the IIF has been working extensively on issues concerning the regulation and supervision of internationally active financial institutions which are engaged in the provision of cross-border financial intermediation. The work of these institutions to support businesses and consumers is directly impacted by the adverse effects of disproportionate divergence in financial services regulation across jurisdictions.

The IIF has contributed to this debate with a study in January 2019 showing that increasing levels of fragmentation undermine the progress that has been made in re-building stability since the great financial crisis.<sup>2</sup> A second paper, later that year, focused on how fragmentation can inhibit or restrict cross-border banking activities, thereby reducing the variety of associated economic and resilience benefits.<sup>3</sup>

This was followed by the April 2022 IIF Staff Paper “Strategic Framework for Digital Economic Cooperation - A Path for Progress,” which warns that protectionist localization measures could hinder the efficiency of international finance and the viability of some business models. Such measures could challenge firms’ ability to serve customers across borders in real-time, efficiently connect customers to capital markets, or deliver secure low-cost payments.<sup>4</sup>

However, despite efforts at the global, regional, and national levels to address these concerns, fragmentary tendencies continue and are in some ways getting worse. Financial institutions continue to experience a broader trend towards diverging home-host standards and approaches; local supervisory measures and ring-fencing extraterritoriality; and obstacles to cross-border cooperation and information sharing. People, processes, technologies, data, budgets, and/or oversight are also often localized as result of fragmented regulatory decisions. This in turn creates significant financial and operational inefficiencies resulting in additional unnecessary costs to end-users and it can reduce the capacity of financial firms to serve both domestic and international consumers.

There is also concern that geopolitical tensions leading to any rise in deglobalization could negatively impact years of positive integration and further affect financial markets and coherence in international cooperation. In particular, warnings have arisen on the consequences of having a global economy which divides into competing systems with different standards.<sup>5</sup> Most recently,

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<sup>2</sup> IIF 2019. “[Addressing Market Fragmentation: The Need for Enhanced Global Regulatory Cooperation](#)” January 24, 2019

<sup>3</sup> IIF 2019. “[The Value of Cross-Border Banking and the Cost of Fragmentation](#)” November 13, 2019

<sup>4</sup> IIF 2022. “[Strategic Framework for Digital Economic Cooperation - A Path for Progress](#)” April 19, 2022

<sup>5</sup> IMF 2020. “[War Sets Back the Global Recovery, World Economic Outlook](#)” April 19, 2022

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the International Monetary Fund (IMF) outlined that the costs of geoeconomic fragmentation (GEF) are likely to fall on trade, migration, capital flows, technology diffusion and the provision of global public goods.<sup>6</sup> These build on growing risks combining lower growth, rising inflation and tighter global financial conditions which may crystallize pre-existing financial system vulnerabilities or give rise to new ones.<sup>7</sup>

With this combination of increased regulatory headwinds and geopolitical tensions likely to persist, challenges to global operating models will continue at pace, ultimately making the overall financial system more fragile. As such, this new IIF paper aims to set out the current state of how fragmentary approaches to cross-border regulatory and supervisory requirements can impact the financial services industry from a market and operational standpoint, and it outlines proposals to continue to address those issues in a holistic and internationally consistent fashion.

### **KEY ISSUES: The Continuing Evidence of Fragmentation**

The G20 rightly recognized the trends in fragmentation and the implications of these trends in 2018 with efforts to mitigate their effects tasked largely to the Financial Stability Board (FSB), in cooperation with the International Organization of Securities Commissions (IOSCO).<sup>8</sup> Since then, the FSB has focused on exploring ways to, where justified, (i) enhance the clarity of deference processes in derivatives markets; (ii) strengthen the understanding of approaches by supervisory and resolution authorities towards pre-positioning of capital and liquidity by international banks; (iii) considering ways to enhance supervisory communication and information sharing, including approaches and mechanisms to avoid future fragmentation; (iv) and considering whether there is evidence of market fragmentation with observed consequences for financial stability as part of the FSB's ongoing evaluation of the effects of too-big-to-fail reforms.<sup>9</sup> Since 2021, the efforts around addressing fragmentation have been incorporated more generally across the priority areas for the FSB workplan.<sup>10</sup>

While this is an example of how international cooperation and coordinated action by financial authorities is vital when addressing issues with cross-border ramifications, fragmentation resulting from excessive regulatory and supervisory divergence – particularly in relation to home/host

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<sup>6</sup> IMF, [Geo-Economic Fragmentation and the Future of Multilateralism](#), January 2023

<sup>7</sup> FSB 2022. "[Exit Strategies to Support Equitable Recovery and Address Effects from COVID-19 Scarring in the Financial Sector](#)" July 13, 2022

<sup>8</sup> G20 2018. "[G20 Leaders' declaration Building consensus for fair and sustainable development](#)" December 1, 2018

<sup>9</sup> FSB 2019. "[FSB Report on Market Fragmentation](#)" June 4, 2019

<sup>10</sup> FSB 2022. "[FSB Work Program for 2022](#)" March 31, 2022

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oversight – continues. This can lead to inefficiencies through duplicative requirements and expectations, result in unnecessary additional costs for customers, exacerbate risks in the local economy, infrastructure, and markets, and cause wider stability concerns.

Financial firms are also increasingly subject to supervisory, regulatory and policy measures around the world that seek to distinguish between operations at the group level versus those conducted at the local entity. These measures are often intended to localize resources, people, processes, technologies, data, budgets, and/or oversight. There are several motivations for this, including safeguarding financial stability, operational resilience, economic sovereignty, and geopolitical security.

However, the resulting “operational fragmentation” could impede the ability of firms with global, group or centralized operating models to effectively deliver business services, enhance efficiency, and bring about consistent risk management controls, thereby reducing the efficiency, security, and resilience of the overall financial system, and limiting the effectiveness of efforts to promote financial stability. Such fragmentation also makes the overall system less resilient to market shocks, thereby undermining the very expectations supervisors may have had by introducing these measures in the first place.

Taken together from a market and operational perspective, there are several specific areas and examples where evidence of certain trends may expose the wider financial system to greater fragmentation:

*a. Local entity rationalization*

In the past, the industry has raised concerns regarding the trend to establish holding company regulations in national circumstances. Specifically, where these rules are not coordinated, effects from overlapping and contradictory requirements across jurisdictions can be observed, creating additional unnecessary friction in the provision of cross-border financial services.<sup>11</sup> The negative implications for global cooperation, financial efficiency, and financial stability have been also highlighted, including reductions to global liquidity, increased borrowing costs for end-users, and a more fragile financial system.

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<sup>11</sup> See “[IIF letter to US Federal Reserve Re: Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies](#)” (April 30, 2013.) and “[IIF Comments on Intermediate Parent Undertaking Proposals](#)” (June 8, 2017.)

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More recently, fragmentary issues have been raised concerning the treatment of incoming branches of foreign banks and investment firms which could lead to the diminishment of this core element of the global financial system. Ensuring the appropriate visibility over the activities of foreign banks operating in a host jurisdiction, safeguarding the protection of investors and the integrity of markets, fostering the development of onshore financial services and markets, and mitigating actual systemic and local risk are legitimate policy goals that are strongly supported by the industry. However, if not dealt with appropriately, the pursuit of such objectives can turn into demands for local incorporation versus branching. Such an action may prove detrimental to the provision of financial services and home-host supervisory and regulatory integration and may not recognize the beneficial contribution of foreign branching to the local economy and to international trade and finance.<sup>12</sup>

Issues for home country regulation on banks with decentralized models should also be considered. In particular, the extraterritorial effect of home regulation (when considered at the consolidated level) has an impact on the activity in the subsidiaries of banks in the host country (as they have to comply with the parent home country law), leading to inefficiencies, increased costs, and level playing field issues.

*b. Supervisory expectations at the local entity level*

Local supervisors can at times implement rules that attempt to address the risk at the level of the supervised entity in their jurisdiction without allowing for how best to address these risks at the level of the whole firm. Specifically, requirements for local entities to hold 'going concern' capital and to have total loss absorbing capacity (TLAC) calculated outside of the group can trap capital, liquidity, and risk in local markets. It can create significant financial and operational inefficiencies that can reduce the capacity of financial firms to serve domestic and international customers as banks consider the business and cost implications of serving certain jurisdictions and at a higher cost borne by customers, and where they have financial stability implications as capital and liquidity is not deployed where it is needed most.<sup>13</sup>

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<sup>12</sup> See for example EU Commission "[EU Banking Package 2021: new EU rules to strengthen banks' resilience and better prepare for the future](#)" (October 27, 2021) and Reserve Bank of New Zealand "[Review of Policy for Branches of Overseas Banks](#)" (August 24, 2022)

<sup>13</sup> See "[IIF letter to US Federal Reserve Re: Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies](#)" (April 30, 2013.) and "[IIF Comments on Intermediate Parent Undertaking Proposals](#)" (June 8, 2017.)

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Fragmentary issues can also arise concerning the treatment of inter-company risks as third-party risks on a legal entity level at the home and the host jurisdictions. Given the progress in resolvability and the establishment of resolution plans for internationally active banks, this gives a case to question whether the risk assessment and regulatory requirements for inter-company flows should be reassessed. In a similar vein, the FSB requirement to hold TLAC which is not pre-committed (i.e., unallocated) as an additional buffer to support resolution requires a formula which takes externally available TLAC and deducting the prepositioned TLAC into subsidiaries and the required TLAC at the parent bank. If the underlying prudential regulation in host and home regimes is substantially different from the group rules (i.e., treatment of inter-company and other regulatory differences in Pillar 2 regimes) the pure existence of the unallocated TLAC formula may lead to further fragmentation.

*c. Expectations for entity-specific local management*

Prohibitions from supervisors around “dual hatting”, where an employee performs functions for multiple entities can be problematic from an operational coordination standpoint.<sup>14</sup> Firms want to retain the ability for such arrangements as they can leverage expertise across entities within the organization. There are also growing expectations that local boards maintain an entity-centric view on global issues such as cybersecurity for which the risks are not localized, and threats arise from across borders. Rather than greater awareness and ownership of risk, the local entity board may not be as risk adverse as the group-level board owing to their inherently more local view of the entity’s operations. This could particularly be the case if local regulations or supervision of cybersecurity risks are less developed than they are in the entity’s home jurisdiction. In this situation, localization of governance and oversight could lead to greater risk-taking which, in the case of cybersecurity, impacts both the local entity and other entities in the group.

*d. Expectations on entity-level controls and risk management*

Localization of risk management processes or specific functions creates duplicative processes and increases risks where there is a siloed/non-group-wide view. For example, risk governance and oversight are being split across many parties which may use different risk and resilience frameworks based on the local jurisdiction. This increases the risk governance complexity, decreases visibility into risk, and results in decreased operational resilience. Additionally, some

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<sup>14</sup> See for example EU Commission “[EU Banking Package 2021: new EU rules to strengthen banks’ resilience and better prepare for the future](#)” (October 27, 2021) and Reserve Bank of New Zealand “[Review of Policy for Branches of Overseas Banks](#)” (August 24, 2022)

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local regulators request that firms move certain functions into certain lines of defense, which can conflict with the financial firm's group-wide practices.<sup>15</sup>

There is often little to no evidence that specific structures generate better risk management. For example, separating cybersecurity from technology would significantly limit the ability of firms to ensure strong cybersecurity policies are embedded into the technology development lifecycle of financial institutions.

Obligations to localize people and processes related to the oversight of third parties also harms the effective management of third-party risk. For internationally active firms, the majority of services are provided and overseen globally in order to drive efficiencies, ensure consistent controls and governance and ultimately serve clients around the world. Staff and resources are therefore optimized globally to meet the needs of clients and best manage firmwide risks.

Conversely, fragmenting third party oversight by requiring onshore staff to oversee such global services adds little value and may confuse important decision-making. More often this results in unnecessary complexity and duplication, creates inefficiencies which may lead to inconsistent controls, stymies shared learning and the implementation of improvements made in other groups or locations, and risks losing control over governance and the creation of potential centers of excellence. One such manifestation has included expectations that reviews and assessments of suppliers be done by local staff rather than group supplier assurance teams that centralize best practices and execution in this area. Local oversight of global services also diverges from how certain continuity planning is optimized; for example, disaster recovery plans are not local – they are developed organizationally for specific functions rather than a single jurisdiction. Local staff across a global organization, which are the recipient of a service, tasked with independently designing what their disaster plans should be reduces the efficacy of such tools.

For firms operating in multiple jurisdictions, regulators' focus on organizational structure, rather than capabilities or outcomes of risk management, can create complexity and hinder firm-wide risk management.

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<sup>15</sup> The ECB, for instance, is known to favor a model in which the cybersecurity function is in the firm's second line of defense. Another regulator requires the information security function to be separate from the IT function and to report directly to the board of directors or general manager. Sometimes, such policies can be more specific such as expecting the firm's red team to be a risk or audit function, rather than part of the security organization.



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*e. Expectations to localize data*

One of the most common examples of continuing fragmentation involves the proliferation of national restrictions on the flow of data, which are often rapidly conceived, disjointed, and poorly coordinated at the international level. Financial firms that enable transactions across borders are watching the rising barriers to data flows with concern that the unintended consequences of these restrictions could not only erode economic growth and limit widely valued digital services across the economy, but also have a detrimental impact on security and resilience of individual financial firms and the sector as a whole. Examples include requirements for systems processing payments data to be located in a country (i.e., India) and rules limiting the movement of banking and financial data (i.e., Switzerland.)

Improving coordination at the international level on free-flowing data, empowered by an open, global internet, can fuel innovation and high-growth sectors around the world. By choking its delivery, these policies threaten the ability of firms to deliver fast, low-cost, and consistent services across many sectors of the global economy. Data localization also potentially undermines the ability of financial firms to identify, protect, detect, respond, and recover when facing ever increasing cyber-attacks as data localization creates obstacles to integrated management of cybersecurity risk within a single organization.

Global firms, including financial firms, deploy firm-wide cybersecurity solutions to protect the firm from internal and external threats. Restrictions and uncertainties around cross-border data transfer challenge the deployment of global cybersecurity solutions that monitor logs and identify malicious activities centrally. Data localization creates obstacles to information sharing between the local entity, which may not have access to global best-in-class cybersecurity solutions, expertise, and resources, and the firmwide team for timely response to cyber threats. This further leads to weakened protection for the local entity which needs to observe data localization rules and become a vulnerability to the firm's global network.

Unfortunately, the industry is witnessing a worsening trend towards data localization, ranging from having to store a local copy of data (no restriction on cross-border data transfer), introducing conditional data flow restrictions or imposing a blanket prohibition on cross-border data flows. There is a strong sense of urgency in tackling the issue, as the global financial sector needs to operate in a secure and resilient manner facing an increasingly complicated threat landscape, in



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line with its own operational needs and regulatory expectations.<sup>16</sup> Similarly, constraints on public-private information sharing on cyber events across borders reduces the overall cyber resilience within and across jurisdictions.

*f. Expectations to localize technology and infrastructure*

Requirements to deploy technology and infrastructure within a geographically confined area or to use technology solutions prescribed by a national authority are also becoming increasingly common. That includes mandated use of a specific anti-virus software within FI systems (i.e., Russia), or for primary and secondary systems through which a service is operated to be kept in a country (i.e., Turkey).

Localized infrastructure in each country increases complexity and makes failures more likely. Common infrastructure that spans borders allow for consistently high security and resilience standards to be applied across the firm. As such, it is important to also recall that expectations of customers and clients are changing, and customers increasingly value the benefits of a seamless digital experience, wherever they happen to be located physically at the time. Customers want choice, and access to the same products, services, and technologies they experience in other jurisdictions.

There are benefits for consumers when a successful product—such as a successful application—from one country can be rolled out in another one. In that case, it becomes difficult when supervisors want the right to approve every software update for that application, teams to be based locally, and data held locally. This can prevent an application from being used globally and effectively. It also undermines security when product teams, such as in the case of supporting a specific application, are separated across jurisdictions, and restricted in what technologies and data can be shared and used.

*g. Expectations on intragroup services viewed as the provision of third-party services*

Some regulatory approaches treat the legal entity as an independent party to the overall group. For example, requirements for locally controlled access to data or systems, such as in the EU and Hong Kong, drive the localization of those data or systems. This assumes that technology provided by the group or other entities (intragroup operations) is equivalent to those provided by unaffiliated third parties for the purposes of outsourcing. In the case of foreign subsidiaries, they

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<sup>16</sup> For further information on data localization, please see: IIF, [“Data Localization: Costs, Tradeoffs, and Impacts Across the Economy”](#) December 2020 and IIF [“Strategic Framework for Digital Economic Cooperation - A Path for Progress”](#) April 19, 2022

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are often also asked to demonstrate an independent capacity to meet local regulatory requirements, and this can result in levels of duplication from the group at every level of consolidation. The impacts of localization requirements for third party oversight, as outlined in Section d. above, further exacerbate inefficiencies when applied to intragroup services.

### **IMPACTS: How Fragmentation Undermines Economies and Financial Stability**

As already evidenced above, all these types of market and operational fragmentation have negative impacts on a variety of important actors - including consumers, firms, authorities, economies - and on financial stability.

Consumers are directly impacted due to higher prices for products and services, driven by inefficiencies caused by fragmentation. Another direct impact is related to consumer safety, as consumers can become victims of malicious and criminal activity, when fragmentation impedes the ability of firms to protect and secure their businesses and operations. The local entities of firms are also hampered when centralized resources, including people, processes, and systems, at firm-wide level can't be deployed as quickly and effectively as possible.

For governments these hurdles and delays also reduce the ability to track and apprehend globally active criminals. That also includes not being able to quickly and seamlessly leverage private sector systems that monitor and help avert fraudulent activities. Innovation more generally is also impeded, when firms can't leverage technologies, systems, people, and processes across other jurisdictions. That will also impact important political objectives such as climate risk, where firms are developing new approaches to help clients transition to a more sustainable future.

Fragmentation between markets, nations, and regions also harms local and global economies. These measures, which might be followed by retaliatory measures, impact the ability of firms to move resources during times of stress, making the overall system less resilient. Fragmentation also makes it more difficult to provide seamless financial services, and to support to corporates and small businesses.

### **RECOMMENDATIONS: Continuing to Address Fragmentary Trends**

It is well recognized that there needs to be sufficient assurance over the ability to supervise financial institutions which operate across borders and that the appropriate safeguards are in place, especially as they relate to critical prudential risk and operational resiliency objectives. To achieve these goals, however, a balance needs to be reached that considers obviating the

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consequences of cross-border fragmentation and preserving adequate access for the real economy to financial intermediation within and across jurisdictions.

As such, we recommend the following issues be considered as regulators and policymakers continue to reflect upon areas of international regulatory and supervisory cooperation and coordination. Taken together, these will help address the continuing issues of fragmentation across markets and across the operational workings of cross-border financial services institutions.

**First**, in the broader context of addressing fragmentation, a number of the issues the industry raised through the initial work of the FSB at the behest of the G20 remain valid. Specifically, this includes, *inter alia*, encouraging greater comparability of prudential regulatory regimes through mutual recognition and equivalence, ensuring the consistency of regulatory and supervisory frameworks, and enhancing accountability in adoption of previously agreed global standards.<sup>17</sup>

Although the industry recognizes the FSB has now moved to incorporate its efforts on addressing issues for fragmentation across its workplan, a more specific approach by the FSB dedicated to tracking and mitigating fragmentary consequences continues to be warranted and should also encompass consideration of the other recommendations outlined herein. The industry would also welcome the G20 emphasizing the importance of building upon existing work to reduce fragmentation.

**Second**, the FSB should further prioritize addressing operational fragmentation specifically and undertake an assessment of current operational risk practices. It can also take stock of current operational fragmentation – including localization, risk, and supervisory practices – and develop an international framework to monitor it over time. The FSB can play a role in collaborating with other global standard setters – including the Basel Committee on Banking Supervision, International Association of Insurance Supervisors, IOSCO and Committee on Payments and Market Infrastructures – to ensure consistency in how supervisors are approaching operational risk. The standard-setters can also enhance transparency and accountability of rules and regulations and the adoption of previously agreed global standards that result in more consistent approaches to operational risk.

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<sup>17</sup> IIF 2019. [“Addressing Market Fragmentation: The Need for Enhanced Global Regulatory Cooperation”](#) January 24, 2019

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**Third**, home-host cooperation and information sharing should be enhanced globally in order to foster a better understanding of the risk profile and vulnerabilities of a cross-border financial institution, both from a market and operational perspective. Supervisory colleges and memorandums of understanding (MOU) should continue to be used to address key topics that are relevant to the supervision of the financial services group (and where possible such discussions should include frameworks in development such as those for critical third parties) in order to better appreciate, for instance, the home regulatory structure of a foreign branch and assist in assessing the equivalence of home-host regulatory requirements.<sup>18</sup> A strong home-host relationship better supports the role cross-border activities play in supporting business and consumers while also mitigating risk. MOUs and information sharing are also important to the emerging regulatory framework in areas such as the oversight of critical third parties.

**Fourth**, the FSB should encourage local authorities and supervisors to consider the broader impact and international consistency of their operational policies and regulations. Building on the first two recommendations above, the FSB can share with local authorities its analysis of current market and operational fragmentation. National jurisdictions should also be encouraged to review the regulations they currently have in place, regarding data, technologies, and operations more widely, and consider how consistent they are with those of other jurisdictions, and in which ways they contribute to making the overall security of the financial system more fractured and less protected.

**Fifth**, there should be enhancements to cross-jurisdictional prudential supervision exercises to promote financial stability. Supervisors should engage in cross-jurisdictional exercises, including penetration testing and stress tests, to rehearse for contingencies for technology failure as an alternative to resilience focused on the national level. They can also consider together how global operating models approach and address operational risks across different jurisdictions.

**Sixth**, outsourcing rules should allow firms to make use of global technologies and processes. Given that intra-group outsourcing on a cross-border basis can reduce overall risk while improving efficiency, supervisors should allow intra-group outsourcing, treat it differently than external outsourcing, and seek instead to ensure that the locally regulated

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<sup>18</sup> IIF 2020. [“Supervisory coordination during the COVID-19 pandemic: observations from the global banking industry”](#) June 19, 2020.

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legal entity is able to show that it is complying with the applicable local regulations and standards regardless of where the technology is located, or risk management is carried out. Different treatment is justified because intra-group services are subject to well-controlled and globally consistent financial industry policies and processes, and those intra-group services which are compliant with recovery and resolution and ring-fencing rules have already met the intended outcomes of several third-party risk management requirements, including those around exit, business continuity planning, and sub-contracting.