Note drafted by the Eurofi Secretariat

FINANCIAL POLICIES FOR DEALING WITH THIRD-COUNTRIES

1. Objectives and characteristics of existing EU third-country regimes

1.1. Objectives and benefits

'Equivalence' is the main approach used by the EU for managing cross-border activity with third-country jurisdictions in the financial sector and is the basis for the third-country regimes contained in a number of EU regulations[1]. It allows financial institutions based in a non-EU jurisdiction determined by the Commission to have a regulatory, supervisory and enforcement regime equivalent to the corresponding EU framework to operate in the EU, relying on compliance with their home country regulation and supervision[2].

From the EU perspective, equivalence regimes are primarily a tool for managing cross-border activity and capitalizing on the benefits of an open and global financial market, in a safe way with regard to financial stability and consumer protection[3], and also maintaining a level playing field vis à vis third-country jurisdictions[4]. These regimes also support regulatory and supervisory cooperation in the areas covered. Although they do not aim to increase market-access possibilities per se, this may be a result of their implementation, thus allowing EU customers to benefit from a wider range of services and products while avoiding regulatory and supervisory overlaps for industry players.

Absent an equivalence regime, third country firms need to establish a legal entity (i.e. a subsidiary in the EU) to provide services across the Union. Nevertheless, individual Member States may still provide access to third country providers in some cases or for certain types of customers, but only to their home market.

1.2. Equivalence determination process

Present equivalence decisions are a unilateral and discretionary decision by the Commission that may decide to adopt, suspend or withdraw an equivalence decision as necessary. Depending on the circumstances, such decisions can take effect after a transition period. The Commission may also grant a time-limited equivalence or set conditions or limits to equivalence decisions. In addition EU equivalence frameworks do not confer to third-countries a right to be assessed or to receive a positive determination.

Equivalence decisions are taken after detailed assessments of the third country's regulation and supervision, on the basis of technical advice from the European Supervisory Authorities (ESAs) concerned. This involves a technical dialogue with the competent authorities of the third country whose framework is being assessed.

Assessments of equivalence are performed for a given jurisdiction and in a particular financial area. This is meant to be an outcomes-based process assessing regulatory and supervisory results (i.e. not a word-for-word comparison of legal texts)[5].

The legal acts of EU legislations set out the conditions and criteria for assessing equivalence and equivalence provisions are tailored to the needs of each specific act. As a result there are differences across financial legislations in the way equivalence mechanisms are built. In its latest Communication published in July 2019, the Commission states that it would be extremely difficult to implement a uniform assessment and decision-making process encompassing various areas of equivalence and that policy-makers, regulators and other stakeholders now accept this heterogeneity as long as some common principles are respected. These principles include having a risk-sensitive approach for determining equivalence guided by proportionality (i.e. assessments should be proportionate to the nature of services and the risks posed to the EU financial system and may, as a result,

---

[1] Jurisdictions across the globe use different methods to manage internally the various risks and challenges deriving from cross-border activities. These methods range from applying the domestic regime in cross-border situations, to deferring to third-country rules and supervisory outcomes, to fully exempting certain cross-border activities – Source Communication from the Commission on equivalence in the area of financial services – 29 July 2019.

[2] This is in line with G20 deference principles. In 2013 during the St Petersburg summit the G20 leaders agreed that "jurisdictions and regulators should be able to defer to each other when it is justified by the quality of their respective regulatory and enforcement regimes, based on similar outcomes, in a non-discriminatory way, paying due respect to home country regulation regimes".

[3] The Commission stated in the recent Communication on "Equivalence in the area of financial services" published on 29 July 2019 that the EU equivalence policy satisfies three objectives: (i) it reconciles the need for financial stability and investor protection in the EU, on the one hand, with the benefits of maintaining an open and globally integrated EU financial market on the other; (ii) it is pivotal in promoting regulatory convergence around international standards; (iii) it is a major trigger for establishing or upgrading supervisory cooperation with the relevant third-country partners.

[4] Equivalence determinations take into consideration impacts on the level playing field in the internal market. They also take into consideration fairness in the treatment of EU players active in third countries and subject to local rules and supervision and also the treatment that third countries afford to EU regulatory frameworks.

[5] According to the Commission 2017 staff working document and July 2019 Communication.

be more demanding for countries whose markets have a bigger potential impact on the EU); enhanced transparency towards the interested third country and the public at large; and an on-going monitoring of equivalence decisions.

1.3. Monitoring and review of equivalence decisions

After an equivalence decision has been granted, it is up to the Commission, in cooperation with the relevant ESAs, to monitor the effects of equivalence decisions and also of any changes introduced over time by third countries to their regulatory, supervisory or enforcement regimes. This involves maintaining a dialogue with third-country authorities. In the coming months, the Commission is due to work with the ESAs in order to step up cooperation on monitoring in line with their respective mandates.

The equivalence frameworks in force do not provide as such specific procedures for monitoring equivalence decisions. Monitoring results feed into a potential review of an equivalence decision, which involves a more structured and strictly defined analysis. Following these assessments the Commission has the power to launch procedures to amend, alter or even withdraw an equivalence decision, when it deems it necessary.

1.4. Financial activities covered

Equivalence regimes are only available for certain financial activities at present. Equivalence regimes exist for financial services related to securities and derivatives transactions (MiFID, EMIR, CSDR, SFTR) and for services and products targeting professional customers and eligible counterparties (investment services under MiFIR, AIFMD) and reinsurance activities. There is also an EU equivalence regime for credit rating agencies and financial benchmarks.

However, most core banking and financial activities are not subject to an equivalence regime providing access to the single market. This includes deposit-taking and lending in accordance with the Capital Requirements Directive; payment services in accordance with the Payment Services Directive; and investment services for retail clients. In addition there is no third-country regime for investment funds targeting retail clients (UCITS and AIFs) and most insurance activities except reinsurance[6].

According to the July 2019 communication of the Commission referenced further up, 17 pieces of EU legislations contain third-country provisions and on this basis over 280 equivalence decisions have been taken for more than 30 countries, across various parts of the financial industry. Further equivalence assessments are underway in areas such as benchmarks and statutory audit.

2. Equivalence arrangements in the context of Brexit

2.1. Equivalence as the basis for the future EU-UK relationship in the financial sector

Once the current transitional arrangements[7] are over, the UK will be considered as a third country and EU passporting rights will no longer apply to financial service providers established in the UK.

Equivalence, when it is available in EU legislation, is due to govern the provision of financial services from the UK to the EU post-Brexit, whether or not the deal negotiated between the EU and UK is finally implemented, since it does not contain any specific provisions for financial services. For financial activities that are not covered by an EU third-country regime the only option is to provide services through an entity authorized in the EU.

This explains why most financial institutions based in the UK that operate at present in the EU on the basis of passporting have set up or developed subsidiaries in the EU27 in anticipation for a hard Brexit. It is generally believed that these changes will allow a continuation of services with no significant disruption post-Brexit. However the impact of these changes on the current financial services market structure in Europe and their implications in terms of cost, complexity and efficiency of the provision of financial services still need evaluating. The current hub-and-spoke model (with the City of London as the hub for many financial activities in the EU[8]) may evolve towards a model closer to a multiple hub model. This is nevertheless dependent to a certain extent on the volume of transfers of activities from the UK to the EU that will eventually happen and on further progress on EU27 initiatives to further develop and integrate financial markets, such as the CMU.

2.2. Issues and questions raised by the existing EU equivalence regimes in the context of Brexit

A number of questions and issues were raised during the EU-UK negotiations on Brexit regarding present EU equivalence regimes, which the UK considered as “inadequate for the scale and complexity of EU-UK financial services trade”. The main criticism made by the UK relates to the unpredictability of equivalence arrangements that can be

---

[6] Source : European Parliament think-tank – Third country equivalence in EU banking and financial regulation – August 2019.

[7] Transtional arrangements put in place by the EU, some EU Member States and also by the UK in certain areas (including derivatives and CSDs) that could be potentially prolonged by an additional transitional phase until the end of 2020 in case of agreement on a EU-UK deal. The UK adopted in November 2018 a temporary permission regime for a period of 3 years for financial firms operating in the EU and that wish to continue carrying out business in the UK. This temporary regime aims to mitigate disruption risks while EU firms seek authorisation or recognition by the UK authorities. The Commission has not provided a similar mechanism for UK-based firms but implemented in December 2018 several contingency measures: (i) a temporary equivalence decision for 12 moths for the central clearing of derivatives, (ii) a temporary equivalence decision for 24 months for CSD services for EU operators using UK operators; (iii) delegated regulations facilitating novation for a period of 12 months of certain OTC derivative contracts being transferred from the UK to an EU27 counterparty.

[8] A range of financial markets, excluding direct retail financial services, have become over the years increasingly integrated and more concentrated with much of the activity and infrastructure either located in London (e.g. securities and derivatives clearing) or managed out of London (e.g. delegation of portfolio management of EU27 investment funds) or accessed through London. Underlying factors include EU single market rules, technology, network effects and the search for scale (economies of scale, competencies...).

withdrawn unilaterally “at any time” by the Commission and their limited coverage in terms of sectors.

Different suggestions were made by the UK to improve equivalence arrangements[9], but these were rejected by the Commission on the basis that they were not compatible with the objectives of the current EU approach to equivalence and would potentially impede the regulatory and decision-making autonomy of the EU. Regarding the predictability of equivalence arrangements, the Commission stressed that although steps and timelines are not strictly defined, a withdrawal of equivalence only happens after an in-depth assessment normally performed by one of the ESAs. Efforts (described further down) are also underway to improve the transparency of the process and public consultation.

Another issue raised by the UK is the perceived “politicization” of the equivalence determination process. This usually refers to the fact that some assessments might take into account criteria that go beyond purely technical regulatory aspects. The Commission however explains that this is normal since equivalence assessments have to take into account several micro and macro dimensions including investor protection, potential systemic risks, as well as AML, market disruption or level playing field aspects, in order to ensure that EU markets and customers are not exposed to unwanted risks as a result of equivalence agreements. Moreover efforts to improve transparency of assessments should help to alleviate these concerns.

3. Improvements made to EU equivalence processes and further proposals

3.1. Improvement of EU equivalence processes

While considering in its working document on equivalence decisions (February 2017) that the experience with equivalence as a mechanism to deal with cross-border regulatory issues is “broadly satisfactory”, the Commission acknowledged that some areas of improvement of equivalence processes needed considering.

Following calls by third-countries and financial industry stakeholders for greater transparency, and accountability of equivalence processes, efforts have been made to improve the information provided regarding the way EU equivalence processes work and how equivalence assessments are progressing. Recently the Commission has adapted its internal processes and generally submits for public consultation draft equivalence decisions with a 30-day feedback period. Suggestions have been made by certain stakeholders that equivalence processes could be further improved without impeding their objective e.g. further increasing the clarity of requirements or defining more precisely possible withdrawal procedures.

The outcome of the European system of financial supervision (ESFS) review should also facilitate the monitoring of equivalence arrangements. Each ESA is to perform monitoring work on equivalent third countries and submit a confidential report to the European Parliament, Council, Commission and the other two ESAs “summarizing its finding of its monitoring activities” on an annual basis. Moreover the review will provide the European Supervisory Authorities with more resources that should allow performing more regular and detailed assessments of the third-countries concerned (including the monitoring of regulatory and supervisory developments and relevant market developments in third-countries).

3.2. Mitigation of systemic risk posed to the EU by third-country entities

A further issue identified by the EU authorities is that third-country jurisdictions may involve different risk exposures for EU financial markets due to the systemicity of their financial sector or of certain entities and that equivalence decisions and their supervision and monitoring need adapting consequently, favouring appropriate cooperation between home and host supervisory authorities.

This issue was addressed in the EMIR 2.2 review regarding systemic third-country CCPs with Brexit as a backdrop. The current equivalence regime entails full reliance on third-country rules and supervisory arrangements and only leaves very limited powers for EU supervisors to intervene should a risk affecting EU financial stability emerge in a third-country CCP. This is considered to be particularly problematic in the case of the UK, given that UK-based CCPs clear a large share of euro-denominated swaps. In addition EU central banks of issue (CBIs) are not involved at present in supervisory decisions regarding these third-country CCPs, which may have implications for EU monetary policies.

In EMIR 2.2. a reinforcement of the supervisory framework for systemically important third country CCPs wishing to provide services in the EU has been adopted, with new monitoring powers granted to ESMA (e.g. in terms of information provision, possible on-site inspections…) and a stronger role for EU CBIs in the supervision process. Systemic third-country CCPs are also requested to comply with some material EMIR rules (or equivalent ones).

Proposals have been made to assess the opportunity of extending this approach to other third-country infrastructures such as CSDs.

---

[9] Proposals made by the UK included putting in place a “super equivalence to UK” for all financial sectors on the basis that the EU and UK regulatory and supervisory starting points are equivalent; transforming recognition into a reciprocal process with both jurisdictions retaining autonomy in decision-making and monitoring arrangements; and also making withdrawal subject to clear timelines and notice periods. The UK also suggested that EU and UK regulatory requirements should be to allowed to diverge over time so long as an equivalence of outcomes is preserved, which would require an on-going and shared review process of equivalence decisions and possibly a specific dispute resolution mechanisms, if the UK is no longer subject to the ECJ.

The Investment Firms Regulation moreover introduces new assessment criteria as well as additional safeguards and reporting obligations for third-country firms established in equivalent jurisdictions in the existing equivalence framework of MiFIR. Under the new equivalence regime different categories of third-country jurisdictions are created. For jurisdictions where the scale and scope of the services provided is likely to be of systemic importance for the Union, equivalence can only be granted following a detailed and granular assessment by the Commission. In addition the role of the ESAs in monitoring the activities of such firms in the Union is enhanced.

3.3. Proposals made at the global level by IOSCO to improve equivalence regimes

In a recent report on "Market fragmentation & cross-border regulation" (June 2019) based on a survey conducted at the international level, IOSCO recognized the potential positive features of equivalence and deference in mitigating fragmentation and fostering global markets.

The areas of improvement identified in this report are consistent with those mentioned by the Commission: insufficient clarity and transparency of the equivalence assessment process and variability across jurisdictions; the difficulty of developing a clear understanding of foreign regulatory frameworks when regulatory philosophies and approaches differ (e.g. principles-based vs rules-based approaches); the frequent lack of "clear processes and procedures" in place for the on-going monitoring of equivalence arrangements; and the possible need to differentiate more between systemic and non-systemic sectors and entities in deference approaches.

Measures have been proposed by IOSCO to improve collaboration and cooperation between supervisors such as making a greater use of its regional committees to discuss regulatory issues on a regular basis and develop more common understanding of the different financial markets and legislative frameworks. Other suggestions made by IOSCO are to provide a central repository of memoranda of understanding (MoUs) in order to facilitate access to them and to increase the use of global supervisory colleges. Suggestions were also made to enhance the clarity and efficiency of deference processes e.g. with the use of common and more standardized material.

Sources used for drafting this paper

Third-country equivalence in EU banking and financial regulation – EGOV (Economic Governance Support Unit) – August 2019

Communication from the Commission on equivalence in the area of financial services – 29/07/2019

Commission staff working document on EU equivalence decisions in financial services policy: an assessment – February 2017

Eurofi Views Magazine – September 2019

Summary of discussions – Eurofi High Level Seminar Bucharest – April 2019