THIRD-COUNTRY EU MARKET ACCESS POST-BREXIT

1. The current features of EU equivalence regimes

1.1. Equivalence provides open access to the EU for jurisdictions deemed equivalent

A policy-maker noted that it is often asked if the EU equivalence system is necessary in a context where markets are increasingly global. This system is necessary because, while financial services are sold across borders, the applicable rules differ. International standards are provided by the FSB, Basel and IOSCO in many areas but these are high level principles meaning that detailed rules and the way they are implemented differ across jurisdictions. Without a supranational, global financial supervisor, different approaches are inevitable. The equivalence system allows the EU to remain open within the global financial system and at the same time to manage financial-stability risks, since there is the possibility of withdrawing equivalence if necessary.

A regulator explained that third-country equivalence arrangements are available notably in several capital market areas such as CCPs and trading venues and also for credit rating agencies. The process for granting equivalence is lengthy and quite challenging both for the EU and third-country authorities, but it is a "generous" and far-reaching system. Once it is granted there is full access to the EU and reliance on home regulation and supervision. The typical alternative that would allow the same level of access is full authorisation and supervision of third-country entities, possibly with certain exemptions, which is the model that prevails in other regions.

A market observer echoed the previous speaker's comments regarding the generosity of the EU equivalence system in the financial sector. The situation is quite different in other sectors. For example, when cars are imported into the EU from non-EU countries there are no equivalent norms. Non-EU manufacturers have to comply with EU norms strictly at all times, and these may change over time. Firms are directly liable to EU sanctions if a non-compliant car is imported into the EU, even if the firm is based outside the EU.

A Central Bank official considered that the benefits that open global financial markets provide in terms of economic growth, efficiency, risk-sharing and supporting financial stability need further promoting. Equivalence is a way to achieve this, with many successfully examples in the EU. The UK has agreed to use this initially to allow non-UK CCPs to operate in the UK after Brexit. The speaker mentioned that the future UK regime is still to be defined. The UK authorities are working on a framework aiming to provide certainty and based on transparent assessments.

An industry representative agreed that equivalence is an effective tool for making global markets function. Benefits for end-clients include access to services at an appropriate price and to a deeper pool of liquidity.

1.2. A system based on equivalent outcomes and deference to the home country

A Central Bank official stressed that equivalence determinations should be based on equivalent outcomes, e.g. by assessing whether regulations deliver the same level of resilience. It should not be a 'line-by-line' or box-ticking comparison. The G20 has also confirmed that deference to home regulation and supervision is the appropriate way to organise supervisory cooperation.

A policy-maker stated that the EU equivalence framework does not require identical rules, it is outcomes-based (i.e. rules are considered as equivalent if they have the same outcome) and is applied proportionately. Outcomes need to be more closely aligned for jurisdictions whose financial institutions are systemic to the EU because it is a risk-based system. That was set out in the EMIR 2.2 and the investment firm review. In these recent legislative texts, rules were strengthened for the more systemic firms, but for non-systemic ones they are largely unchanged.

A regulator broadly agreed with the need for outcome-based equivalence and confirmed that this has been the case for all recent EU equivalence decisions. Out of 31 decisions the speaker has been involved in, only one had necessitated some extra rules and that was in a very specific area. The assessment process was moreover transparent, has been detailed and results are publicly available. There are however limits to what is possible with an outcomes-based approach because of regulatory arbitrage risks and possible weaknesses that might develop in the system as a result of it. In some cases greater consistency of rules is necessary to avoid regulatory arbitrage. This has been the case within the EU where there has been an evolution towards the use of regulations rather than directives. There may therefore be limits to the use of an outcomes-based approach to equivalence in the case of the UK financial system, given its strong interconnectedness with the EU.

2. Changes expected with the review of the ESFS and the implementation of EMIR 2.2 and the investment firm review

A regulator noted that some changes to the EU equivalence system have been initiated because of issues posed for EU supervisors. A first issue are the resources and time needed to perform equivalence assessments, which sometimes hinder progress, because it is not only individual firms that need to be assessed, but the whole regulatory and supervisory system of a third-country jurisdiction. The European system of financial supervision (ESFS) review will provide the European Supervisory Authorities with more powers and resources that should allow performing more regular assessments of the third-countries concerned.

A second issue relates to the relative "generosity" of the current equivalence system. There is a question of whether it is responsible for EU supervisors to always fully rely on the supervisors of third-countries deemed equivalent to appropriately manage risks to the EU27 that might come from that country. This has led to providing EU27 supervisors with additional powers in certain cases. This issue has been tackled with EMIR 2.2 concerning third-country CCPs. Tier-one CCPs (non-systemic ones for the EU) will continue to operate under the current equivalence arrangements but tier-two CPPs (systemic ones for the EU) will have a direct supervisory relationship with the EU with the possibility of comparable compliance. Similar steps have been taken in the investment firm review. That is welcome because MiFID II regarding professional services is reliant on a patchwork of national systems, creating the risk of regulatory competition. As a result it may be more attractive under certain parts of MiFID II to service EU customers from

outside the EU rather than from inside, justifying additional measures in the investment firm review to repair this.

An official agreed that the investment firm review and EMIR 2.2 regulation offer improvements. The old regimes were not designed for a potential Brexit situation resulting in a major financial centre with systemic institutions for the EU outside the Union, so differentiating in a proportionate way between more and less systemic institutions in the way equivalence is applied is key. In addition equivalence cannot be a one-off box-ticking exercise, especially for institutions that are systemic for the EU, as it is essential to be able to track possible evolutions that may happen on the ground. The future basis will be cooperation between supervisory authorities in order to examine how rules are applied and implemented over time. Cooperation must also be implemented in a proportionate way. More systemic institutions that are highly relevant to financial stability require more intense supervisory cooperation. A policy-maker confirmed that although requirements have been strengthened in the context of equivalence arrangements for systemic CCP and investment firms, they remain unchanged for the other ones.

The Chair noted that these changes will presumably be applied erga omnes to all jurisdictions and not only to the UK as there must be a level playing field across jurisdictions.

3. Predictability of equivalence arrangements

3.1. The process for withdrawing equivalence

A Central Bank official stated that equivalence arrangements must provide market participants with sufficient stability and confidence over time. In theory, equivalence can be withdrawn at no notice according to the EU framework, which goes against the objective of stability. Market participants need to know that decisions will be maintained and that any necessary changes will be phased in over time. In addition there should be a review process of equivalence decisions. Rules should be allowed to diverge to a certain extent over time, provided that resilience and consumer protection outcomes remain equivalent. This is why equivalence assessments must be based on outcomes. An industry representative agreed that there is potential to improve the EU equivalence system. The possibility of short-notice withdrawal is the main concern regarding these arrangements, given potential consequences for customers. A more effective and transparent process for addressing any divergence or disagreements between the EU and UK would improve the reliability of equivalence arrangements and facilitate planning by industry participants.

A policy-maker responded that the withdrawal of equivalence is not a “light process” and if it is eventually decided, this is the result of an in-depth assessment normally performed by one of the ESAs at the request of the Commission. This is also usually a public and transparent process during which sufficient time is left to react to the advice provided by the ESA. Therefore it is difficult to say that withdrawal happens at no notice. Moreover reviews of changes in situations are an on-going process that is already performed. This is the case for example if a third-country changes its rules significantly, if there is a break-down in trust between supervisors (e.g. related to money-laundering issues) or if a third-country starts discriminating against EU firms. The EU might also change its own rules, which would require a review of third-country rules against the new ones.

The Commission and the European Parliament also recognise the need for predictability, resulting in improvements made in the context of the recent investment firms review. The process that may result in the withdrawal of the registration of a third-country firm is framed in great detail and has been thoroughly thought through. There must be evidence of divergence and dialogue with the home supervisor and withdrawal only happens in situations where it has not been possible to find remedies. In addition an article of the investment firm review establishes that the Commission will issue an annual report on how equivalence powers are used. This reporting is specifically for investment firms for the moment, but the intention is to move towards a broader and more regular public reporting on equivalence arrangements both concerning the past and what is intended in the future.

The Chair questioned whether there is the intention to put in place a more defined procedure including mandatory legal timeframes for decision-making in order to avoid equivalence decisions being strung out for political reasons. The policy-maker responded that the current process is public and sufficient time is left to react to the advice provided by the ESAs, but strict timetables are not being considered. An official agreed that it is difficult to tie the review of equivalence arrangements to short timetables, unlike merger cases for example. However over time it is expected that the process can move towards more predictability in terms of steps and timelines. The first annual report of the Commission on how equivalence powers are used should provide Member States and the EU Parliament with an opportunity to discuss present arrangements.

3.2. Tackling systemic risks posed by third-country institutions in the context of equivalence arrangements

A market observer stated that it is necessary to maintain the capacity to withdraw EU equivalence agreements at short notice if discrepancies develop between the EU and third-countries deemed equivalent, relating to regulations and their application and if this poses systemic risks to the EU. The fact that jurisdictions trust each other today does not mean that it will always be the case if the government or parliament changes and political objectives may evolve.

Secondly, it is difficult for third-country authorities to address all issues concerning the EU and the equivalence system must not be taken to the extreme. For example, it is difficult for a Central Bank to commit to delivering the liquidity needed in a crisis if it has no say in the regulation of the entity concerned. If a problem happens within the Eurozone, the ECB may request changes to be made to the practices of a given CCP to allow the Eurosystem to step in with liquidity if necessary, even if the ECB has no direct power over this CCP. But if the CCP is in a different location outside the EU then the ECB has no power even if there is a commitment to provide liquidity via a swap. This is also very much a question of relative weight. If the EU market relies nearly totally and for a long period of time on a monopoly situated outside the Union, as with certain types of derivative contracts on which the UK has a quasi-monopoly, then Central Banks in the EU cannot commit to providing liquidity and the potential systemic risk is “enormous”. Conversely, when this is not the case and some derivative contracts are abroad but important contracts are within the remit of a Eurozone Central Bank, then it is easier to work on the basis of equivalence. This is not a problem at present, but could become one after Brexit.

A Central Bank official commented that independent Central Banks do not typically guarantee to extend liquidity solely because an equivalence arrangement exists. Existing and strong supervisory and Central Bank cooperation arrangements can however be built on. This cooperation ensures that a Central Bank can feel confident in extending liquidity in its currency via a swap line to another Central Bank – and not to a private sector entity - because it has the appropriate insight and information. The domestic Central Bank can then take the credit risk of lending to the party concerned if this is necessary.

Brexit, depending on its final outcome may challenge the current equivalence system, an official stated. The starting point is an identical set of rules, but the EU will need additional safeguards to tackle potential financial stability risks that may develop with the UK leaving the Union. The most prominent issues have been tackled with EMIR 2.2, but problems may appear in other areas. Once all these issues have been addressed, the EU will probably be content with granting equivalence to the UK for a wide range of activities. A challenge will however come when the EU amends its regulatory framework at a future point in time to better mitigate risks and if the UK supervisor, either for technical or political reasons decides that they do not want to follow these changes because they do not want to be a rule-taker. How to deal with that possible challenge will be the real issue for the EU regarding the equivalence process, the speaker believed. Predictability is an important aspect but the EU also needs to be able to adapt its rules, if needed.

The market observer noted that Brexit will remove the authority of the EU supranational institutions (notably the ESAs) created in the aftermath of the crisis vis-à-vis the UK. That is also a potential risk for the interpretation and implementation of the regulations, even if they stay the same. The UK public authorities will continue on the same lines for a time, but future evolution is uncertain.

4. Issues related to equivalence determination

4.1. Standards according to which equivalence should be assessed

A Central Bank official considered that international standards, when they are available, should be the basis of outcomes-based assessments for equivalence determinations between the EU and third-countries. Much has been done to promote consistency of rules on a global basis through the work of a variety of global standard setters. Using these standards will ensure the stability of equivalence arrangements over time and facilitate deference to third-country authorities in line with the G20 intent.

The Chair believed that international standards are fine, but not granular enough at present to be a basis for equivalence arrangements, so an individual evaluation of the equivalence of jurisdictions will still be necessary. However moving towards more granular international standards and a consistent implementation of these is an important objective going forward in order to avoid creating a complex matrix of bilateral equivalence determinations, as the number of significant capital markets increases internationally. A market observer added that international norms are far from covering all financial sectors and agreed that their limited granularity means they can be interpreted differently. Jurisdictions who trust each other today may not tomorrow, if governments, parliaments or the atmosphere change.

A Central Bank official replied that comparing the specific wording of two sets of rules to determine equivalence does not work. It is outcomes that must be assessed. For example the outcomes of clearing requirements applying to CCPs are very clear. They include requiring CCPs to hold financial resources to allow them to withstand the default of their two largest clearing members in extreme but plausible stress events. It is possible to assess whether the same level of resilience is achieved even if detailed rules are somewhat different across jurisdictions.

4.2. Resources and time needed

The Chair raised the question of whether there could be a first-mover advantage to the detriment of the UK if the EU has multiple equivalence determinations to perform with different regions and resources are too limited to conduct them simultaneously. An industry representative considered that the UK financial services sector is currently in a situation where all rules are equivalent to the EU. This should be the starting point, and a couple of years should be allowed to figure out the future roadmap. The Brexit cliff edge is often talked about but there is also an equivalence cliff edge. A great deal of anxiety had arisen among clients around whether UK-based CCPs would get an equivalence determination before this was eventually agreed. Defining how regulatory cooperation will work in the future between the EU and the UK, together with a transparent timetable for implementation, should be the priority, rather than spending all the time planning for a no-deal tail-risk.

Another industry representative suggested that moving towards a more consistent and horizontal approach to equivalence arrangements across sectors and regulations would also be an improvement. This would avoid starting each assessment separately from scratch and help to reduce the duplication of work across equivalence assessments, which are very resource intensive. More resources dedicated to these processes would also allow the improvement of the predictability of equivalence determinations in terms of delays.

The Chair added that the more intensive monitoring of equivalence arrangements once they are agreed in the case of the UK would also be potentially very demanding in terms of resources, which is another factor worth considering.

4.3. The potential technical and political dimensions of equivalence determinations

Answering a question about the possible political dimension of some equivalence determinations, a Central Bank official considered that they should be purely technical.

A policy-maker stated that the distinction between the possible technical and political nature of equivalence assessments, which is often raised concerning EU equivalence arrangements, is too limitative. Equivalence assessments are not technical box-ticking exercises. As rules are reviewed and compared between jurisdictions different elements come into consideration. For example banking rules would not be declared equivalent if there are money laundering issues. Insurance rules would not be declared equivalent if there are auditing issues and the underlying accounts of firms cannot be trusted. Assessment is therefore more comprehensive than a technical box ticking. The chair noted that clarity on the definition and objective of equivalence assessments and the way to conduct them is essential.

An official stressed that equivalence supervisory arrangements rely on reciprocity, so the better the cooperation between supervisors is and the more technical the approach is from both sides, the more reliable the process will be. The risk of politicisation cannot be ignored. Both sides must be aware of this and endeavour to keep the process as technical as possible and managed between supervisors. The existing process offered by the Commission is based on factual and objective assessments, which puts the EU in a position to react if it becomes unduly politicised from the other side.

An industry representative believed that equivalence should be primarily a technical assessment, evaluating if different rules provide the same level of safety and efficiency for a specific product or activity. Involving politics in this process changes the way assessments are conducted and that is not the objective. It is important also to consider the end state following an equivalence decision. For example, the risk that an equivalence decision may create a situation where one system becomes fully dependent on another for certain products or activities, that was previously mentioned regarding certain derivative products, can be considered as part of the technical assessment. Avoiding political interference requires greater supervisory cooperation in order to monitor

evolutions and foster a better understanding of each other's motives and preoccupations.

Another industry representative noted that the so-called political aspects of equivalence are often at the point of entry when it is granted, so appropriate cooperation is needed from the start of the process. A third industry representative considered that politics are hard to eliminate in this context. One difficulty is that the UK does not want to be a rule taker due to the importance of its financial sector. If it ends up in this situation, the discussion risks becoming quite political and antagonistic between the EU and the UK. A fourth industry representative emphasized the importance of having sound judgement despite the uncertainty of Brexit and the related transition. This involves making sure that relevant rules and laws are being appropriately enforced in any case.

5. Future supervisory cooperation and information sharing between the EU and the UK

The Chair noted that equivalence determinations take place at a discrete point in time. The difficulties arise when laws start to diverge. Managing this requires monitoring and resources. An industry representative considered that trust and transparency between the regulatory communities and participants is fundamental for the future EU-UK relations.

Another industry representative emphasized that the first level of cooperation is information sharing, which is not always easy. Large banks deal with different authorities worldwide; it is difficult to fulfil all expectations and in some cases there are restrictions concerning the information that can be shared. This requires the establishment of memoranda of understanding (MoUs) in order to avoid banks being faced with contradictory or duplicate requests. The second level of cooperation includes regular interactions between supervisors and the private sector. This helps to better understand for example the practical implications of regulations in terms of IT systems, information and reporting, which are not always fully considered. Even a basic requirement may require a huge amount of work to put in place. Better information sharing between regulators and the private sector would also help in this respect.

Supervisory cooperation is a "two-way process", the industry speaker stated, which makes it quite challenging. Different regulatory and political decisions will drive developments going forward, but the way the market evolves as a consequence and the behaviour of large market participants in this context also need to be considered. A broad understanding of the situation is required, as is the sharing of information and the reciprocal understanding of red lines in order to develop the future market in a harmonised way. The objective is to move to a new equilibrium in the market post-Brexit, and to ensure that the transition towards this new situation is as short as possible with minimal disruption. The better this is planned and managed jointly between the public authorities and the industry in the EU and UK, the easier the transition will be. It requires understanding and working together. Public-sector initiatives will drive evolution, but private market participants' reactions will be important also. In addition this must not be limited to the EU and the UK, because other financial centres outside Europe are actively operating in Europe and need to be considered as well.

A regulator noted that exchanges with third-countries based on an MoU during equivalence assessments and subsequent work have gone well. Supervisors tend to rely on each other due to limited resources. The UK however will be a third-country in a specific situation post-Brexit, with a capital market very highly interconnected with the EU. Information currently exchanged between the UK and the EU27 goes far beyond what can be usually managed with an MoU. There are far-reaching reporting requirements on both sides, involving specific formats e.g. concerning data needed for market abuse supervision or to support the MiFID II transparency regime. The result is that EU and UK markets will continue to be highly interconnected post-Brexit, but regulated from two different standpoints. Hence, we will need to consider how to cooperate with the UK regarding data exchange issues. These data issues will be difficult to tackle with just an MoU.

A Central Bank official felt that supervisory cooperation is often discussed as a burden or an additional cost, which is not the case. Experience shows that cooperation creates a better outcome. The lead supervisor's process benefits from the other authorities' input, insight and resources when combined inspections of financial entities are conducted. Cooperation also works well between Central Banks and underpins the availability of swap lines, should they be needed.