Optimizing third-country approaches in the financial sector

John Berrigan

Director-General, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

EU equivalence policy – a tool for regulatory convergence

The EU is one of the most open financial systems in the world, with very significant financial flows to and from the EU. There are hundreds of non-EU players in the EU market and EU players are present in all financial systems around the world.

The key instrument, with which the EU manages risks deriving from interconnectedness and exposure to third-country financial systems, is equivalence. Equivalence is about risk management - ensuring that financial stability, market integrity, and the protection of EU investors and consumers are safeguarded, even when there is a level of deference to a third-country authority.

The key questions before granting equivalence are: will the third-country authorities manage risks for EU firms the same way as they manage their own? Even more importantly, in case of a crisis, does equivalence ensure that we can really rely on third country authorities to manage risks for our own economic operators?

The Commission has an established practice of deferring to and cooperating with third-country supervisors; 280 equivalence decisions have been granted in respect of more than 30 third countries. With its Communication of 29 July 2019, the Commission has reaffirmed that risk management is the cornerstone of its equivalence policy. It has also reiterated that equivalence requires a risk-based and proportionate approach. This means that the higher the potential impact of a third-country market on the EU, the more thorough the equivalence assessment.

The Communication highlighted that trust is essential to underpin deference and that EU foreign policy priorities are relevant for equivalence assessments, including for instance anti-money laundering arrangements and/or tax governance.

The Communication summarised recent developments, such as the targeted amendments to third-country regimes, in particular for Investment Firms, for CCPs and the enhanced role for the European Supervisory authorities, notably on monitoring equivalence decisions.

On process, the Communication detailed further transparency steps, e.g. through its better regulation practice of public consultation periods before adopting decisions. It presented plans to systematically monitor existing decisions. Normally, this would take place through dialogue with the Commission affording an opportunity for the third country to remedy any gaps identified. If gaps cannot be remedied, equivalence can be withdrawn as in the case of some Credit Rating Agencies decisions in July 2019. If conditions for equivalence were to change more suddenly, the process leading to withdrawal might become more rapid.

Equivalence policy is fit for purpose for the assessments of the UK, as for other any third country. It will be a key tool to handle EU-UK relations in the financial sector in the future. Irrespective of the outcome of equivalence assessments, UK-based financial institutions will lose their access to the single market based on their UK authorisation after the transition period. Those UK institutions that want to guarantee the provision of services to EU clients across the single market are aware that they will need an establishment in an EU Member State. Ultimately, it is a choice for each firm to decide how it organises itself and which clients it wants to serve.

On the risk of cliff-edge at the end of the transition period, the situation is different from the no-deal risk in 2019. The Withdrawal Agreement provides sufficient time for firms to take the necessary steps to cater for the change in their regulatory regime. Firms need to use the months left until the end of transition period to adapt their operations. Overall, counting from the day of the referendum in 2016, they will have had four and a half years to prepare.

The Commission will constructively engage with the UK in all equivalence areas and gather facts, with the intention of concluding its unilateral equivalence assessments by June 2020. However, the deadline refers to the mapping, not to the decisions themselves. Further, the UK's stated intention to diverge from EU rules makes assessments more complicated. Equivalence is typically the outcome of a convergence process but, in the case of the UK, the Commission will need to consider the extent of possible UK divergence in its initial assessments. This implies a thorough and forward-looking assessment of how the UK regulatory and supervisory framework will operate after the transition period, and whether it will deliver similar outcomes as the respective EU framework.

Steven Maijoor

Chair, European Securities and Markets Authority (ESMA)

Enhancements to the EU equivalence framework

Effective cross-border regulation and supervision is an essential prerequisite for the development of strong, efficient and safe global financial markets. In this regard, open access to financial markets needs to go hand-in-hand with an effective supervisory toolbox for authorities, in both home and host jurisdictions.

The financial market regulatory framework in the European Union (EU) offers market access by market participants from third countries based on equivalence and recognition regimes. While not available to all sectors, these regimes still constitute, from a global perspective, the most extensive application of the "deference" principle agreed back in 2013 by the G20.

Internationally active market participants have benefitted in the past years from the aforementioned European approach, and market fragmentation has been kept limited in areas such as securities trading and clearing.

With the United Kingdom leaving the EU, which has Europe's largest capital market, the EU needed to accelerate the improvement of third-country arrangements as they were designed many years ago. In January 2020, a number of important changes in the EU equivalence and recognition frameworks became applicable, without, however, changing the main underlying principles of these frameworks.

Firstly, ESMA will continue to play an advisory role to the European Commission regarding the assessment of non-EU regulatory and supervisory frameworks in order to facilitate equivalence determinations. In addition, ESMA will take up the important task of monitoring relevant developments in those areas and jurisdictions where equivalence has been declared. To this end, ESMA will strengthen its ongoing cooperation with non-EU regulators and seek to better understand their domestic frameworks as well as their effectiveness. The revised ESMA Regulation requires ESMA to report on its monitoring activities to the European Institutions on an annual basis.

Secondly, in relation to CCPs, the EU introduced a more proportionate framework for the recognition and supervision of non-EU market participants. In particular, EMIR 2.2 sets out an enhanced recognition regime for systemically important third-country CCPs, whereby such CCPs will have to comply with EMIR requirements and be subject to certain supervisory powers of ESMA's. The current arrangement with ESMA's full reliance on non-EU supervision will continue to apply with regards to all non-systemic third-country CCPs. The final legal framework allowing ESMA to distinguish between systemically important and non-systemic CCPs has however yet to be established.

ESMA will take up the important task of monitoring relevant developments in those areas and jurisdictions where equivalence has been declared.

Thirdly, enhancements were also introduced regarding non-EU Investment Firms (under the Investment Firms Review legislation), and here ESMA will receive improved monitoring and information powers as of mid-2021 in relation to firms from equivalent jurisdictions.

Fourthly, and finally, the revised ESMA Regulation contains a requirement for the European Commission to provide, in due course, a report regarding the need to enhance equivalence arrangements, with a possible supervisory role for ESMA, in relation to non-EU trading venues and CSDs.

Looking at these examples, it is clear that the EU equivalence regimes are changing. On the one hand, the equivalence frameworks will continue to be an important arrangement allowing to avoid market fragmentation while preserving open markets and a level-playing field between global market players active in the EU. On the other hand, a more proportionate approach to systemic and non-systemic non-EU market players is needed, combined with direct supervisory powers at European level, in the interest of EU financial stability and investor protection.

Shinzuke Toda

Managing Executive Officer, Deputy Head of EMEA, Mizuho Bank, Ltd.

The longevity of the equivalence framework in a post-Brexit world

The enhancements proposed to the EU approach towards cross-border regulation and supervision of third country entities include a more granular perspective in respect of determinations of equivalence where there is systemic risk and ongoing monitoring of compliance with applicable standards by the European Supervisory Authorities (ESAs). However, the increased scrutiny and consequent increased risk of withdrawal of equivalence poses serious risks to business continuity for market participants and the wider health of the European economy as there is an inherent paradox where compliance with internationally agreed standards does not result in the maintenance of equivalence. This is particularly the case when equivalence is used as a political tool rather than to promote the integrity and resilience required for the financial markets to flourish. Outcomes-based equivalence, based on compliance with international standards (such as the Basel accords), should therefore be the preferred option and we urge policymakers to prioritise the principles of objectivity, proportionality and risk sensitivity.

There will be greater scrutiny of delegation, outsourcing and material risk transfers (such as back-to-back business) to third countries by the ESAs, which is welcomed to ensure effective supervision and enforcement in respect of third country players, provided that the regime is proportionate and the rules are clear as to what is permitted. The increased cooperation of the ESAs with third country regulators is welcomed; as seen in the Japan / EU EPA, regulatory cooperation should reduce the risk of regulatory arbitrage and ensure a level playing field for non-EU players. It is important to remember that although the enhancements to the third country regimes have arguably been motivated by Brexit, the changes will also affect any non-EU firms operating on a cross-border basis into the EU (including those in the US and Asia). This strengthens the argument that any changes in enforcement should be proportionate. For this reason, special consideration should be given to equivalence regimes between the EU and third countries to develop stable and resilient regulatory relationships that do not significantly affect financial links between the EU and these jurisdictions.

In relation to Brexit, both UK and EU financial markets will inevitably be harmed by the UK's withdrawal. Although marginally differing regulatory regimes may be necessary to respect sovereignty, material gold-plating of requirements may trigger third country banks to consider the extent of their presence and business model in Europe. Regulatory divergence would result in (i) operational inefficiency due to the need for greater investment to set up operations in each jurisdiction, losing the economies of scale of a centralised model (ii) higher transaction and compliance costs, caused by different procedures and documentation required under different regulations, (iii) reduced liquidity if, for example, investors in the EU cannot invest in certain UK markets, ultimately impacting investor demand and (iv) more restrictive market access, which is highlighted by the potential loss of an EU passport for UK incorporated financial institutions after the transition period. Specifically, we would welcome UK CCPs being declared equivalent after the transition period to ensure that EU participants may continue to use them for clearing. Another market concern seems to be that UK and EU derivatives trading venues should be declared equivalent so as not to adversely affect liquidity and to allow UK and EU market participants to trade on the same venue (known as the derivatives trading obligation under MiFID II).

Therefore, we would welcome the EU maintaining close cooperation and dialogue with the UK post-Brexit, to preserve a consistent regulatory and supervisory framework and to encourage investment in the region as a whole. The reduction of market fragmentation was highlighted as a key priority during Japan's presidency of the G20, as well as by IOSCO and the FSB. We hope there will be a move towards greater globally harmonised financial regulation through increased home state recognition of regulatory and supervisory frameworks.

Beatriz Martin Jimenez

Investment Bank Global Chief Operative Officer
& UK Chief Executive, UBS

Outcomes-focused equivalence is key to delivering the EU's Capital Markets Union

There is broad agreement among regulators, policymakers and market participants on the risks that market fragmentation present to financial and to some extent operational resilience. Last year, the G20 and the FSB recognised that a coordinated policy response is needed to address these risks while IOSCO acknowledged a role for deference in the regulation of capital markets, complemented by measures to strengthen regulatory and supervisory collaboration. Despite this recognition, we continue to observe divergent implementation of global rules, while mutual recognition of rules by regulators is not widely applied.

In the EU, the Capital Markets Union (CMU), which aims to broaden the funding base for European corporates and households, remains a key project. UBS and other global firms want to play a role in making the CMU a success by continuing to facilitate capital, liquidity and investment flows into Europe. The CMU is fundamentally about breaking down barriers to these flows in Europe's capital markets and as such is an important channel through which market fragmentation issues can be addressed. However, achievement of this goal risks being undermined by insufficient trust by host regulators of firms' home regulation, both within and beyond Europe.

The EU has developed an equivalence framework which could become a powerful tool to allow cross-border business to be conducted safely and to high standards, to the benefit of EU firms, households and the overall economy. In order to achieve this, equivalence decisions must be grounded in a technical analysis that focuses on ensuring that third country rules achieve the desired outcome, taking into account relevant international standards; and to deliver legal certainty, the process must be consistent and transparent.

The EU's financial sector is highly integrated with that of key third country partners, including Switzerland, which has substantially reformed its regulatory framework to align with MiFID II standards. Yet the absence of a reliable equivalence mechanism could disincentivise convergence towards the EU, with consequences for businesses, savers and investors both in and beyond the EU if financial integration is eroded. The lapse of EU equivalence for Swiss trading venues just over a year ago illustrates the lack of legal certainty third country partners face with the current system. A more structured and predictable process for equivalence, supported by robust regulatory and supervisory cooperation, would underpin market confidence and stability.

As we look beyond the current concerns with COVID-19, it will be important to deliver clarity on the regulatory framework that will apply at the end of the UK's Brexit transition period as a matter of priority. Even as firms including UBS establish additional EU hubs, the financial sector needs assurance that all relevant equivalence decisions will be in place on both sides and applied by the EU and the UK in a coordinated fashion well before the end of the transition period. Equivalence is key both to avoid any market dislocation and, given that London remains an important centre for liquidity and term funding as well as for European and international talent, to maintain the investment flows that support the functioning of Europe's capital markets.

Going forward, if we are to achieve the full benefits of efficient and safe pan-European and globally-integrated capital markets, any temptation to establish new barriers that could ultimately inhibit the CMU's ability to deliver increased competition, choice and innovation, such as disproportionate requirements on third-country firms wishing to provide cross-border MIFID services to wholesale clients, should be resisted. Building the CMU in a way that integrates an outcomes-focused, transparent and consistent equivalence framework must be a priority. It will lead to more legal certainty, lower costs and higher productivity for all market participants and customers.