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The cross-border regulation of financial services after Brexit: what role for the EU equivalence regime?

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After Brexit, the UK's financial industry will lose its EU 'passport'. But financial providers established in the UK could still cater for EU clients on the basis of equivalence decisions adopted by the European Commission. To what extent can the EU equivalence regime alleviate the loss of passport rights for UK firms? Equivalence access is only available for certain financial services and products and can be withdrawn by the European Commission at any time.

Equivalence is a moving target. Significant amendments have been recently introduced to EU equivalence rules related to market infrastructures and the prudential treatment of investment firms, and in the amendments to the European Supervisory Authorities regulation.

This CEPS-ECMI event discussed the effects of the EU equivalence regime and its overall role in the Brexit context. It considered questions such as under what regulatory and supervisory requirements will the EU grant equivalence access to the UK? How far will the equivalence process be linked to political and non-regulatory issues? Also, how will the UK use its equivalence policy? Will it want to seek equivalence or will it be comfortable with diverging from EU regulation?

Speakers:

Almorò Rubin de Cervin, Head of Unit International Affairs, DG FISMA, European Commission
Niamh Moloney, Professor of Financial Markets Law, London School of Economics
Jakub Michalik, Senior Officer, European Security Market Authority
Julien Jardelot, Head of Post-Trade & Technology Regulatory Strategy, London Stock Exchange Group
Pablo Portugal, Managing Director of Advocacy, AFME

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The report is not a transcript of the speakers' interventions; rather, it should be understood as an interpretation of their views by the authors.

Equivalence in the EU

Equivalence is an instrument that allows the EU to manage cross-border risk and exposure to third country activities, while ensuring continuity of services (in the context of regulatory change) without the need to establish a presence in the EU. It is not the only tool available, however. There is a significant third country dimension to EU financial regulation, in supervisory discretion (e.g. when supervisors assess business models), in supervisory cooperation, but also in various forms of recognition (e.g. recognition linked to equivalence, recognition linked to the Minimum Requirement for Own Funds and Eligible Liabilities, MREL). There are thus various aspects to dealing with third country risk. Equivalence is perhaps the most reasonable, but certainly not the only one.

Equivalence plays an important role in the functioning of the EU capital markets. It facilitates open capital markets, welcomes investments from other jurisdictions, ensures access of European investors and market participants to the best possible available liquidity pools, while remaining connected to international markets. Given the transnational nature of market-based finance, equivalence is also adaptable to different contexts and relationships.[1] In addition, the EU equivalence framework has been acknowledged in a global context[2] as one of the most efficient and effective ways (among other deference models) of avoiding market fragmentation.[3] No other jurisdiction allows such a vast array of financial activities to be conducted on its territory by entities established outside its geographical borders.

Today, EU financial services law includes about 40 areas for equivalence decisions,[4] while the European Commission (EC) has adopted more than 280 equivalence decisions in the area of banking and finance for more than 30 countries.[5] Equivalence can broadly be described as a deference-based system. Once a jurisdiction is considered equivalent to the EU, access to the Single Market (SM) is possible without the need of a strong onshore regulatory and supervisory presence (i.e. limited direct application of the EU laws). In other words, deference can be thought of as a 'courtesy to the host country'.

The equivalence decisions differ from one another in what they do, both in terms of market access and supervisory requirements. Furthermore, the context in which the equivalence decisions are taken is relevant.[6] For this reason there is no one pattern to the way equivalence is designed, not only because risks differ but also because there are different elements of proportionality.

[1] Within this field, the European Commission can grant ‘passport-like’ market access to the Single Market to foreign central counterparties and trade repositories (EMIR), investment firms (MIFIR), alternative investment funds (AIFMD), credit rating agencies (CRAs), central securities depositories (CSDR) and trading venues (MIFID II/MIFIR).

[2] See IOSCO’s Report on ‘Market Fragmentation and Cross-Border Regulation’ of June 2019.

[3] Equivalence entails an element of predictability, as the recent Commission’s repealing decision on CRA Regulation equivalence showed. However, reliance on business continuity moves from the private sector (which applies for registration with the foreign regulator) to the public sector (which has to work out equivalence assessment and decision).

[4] 40 provisions that allow the European Commission to adopt equivalence decisions.

[5] See the European Commission’s Communication of 29 July 2019 on equivalence in the area of financial services, as well as the overview table with the equivalence/adequacy decision taken by the EC.

[6] For instance, when there are sanctions in a given country, equivalence might be difficult to grant. Similarly, anti-money laundering or tax-listing problems may also affect the equivalence decision. Beyond what is written in a specific framework, carrying out the assessment exercise can reveal factors that regulators did not consider at the beginning.

Equivalence is not an 'one-size-fits-all' approach, it has drawbacks and it can be patchy. In particular, four key drawbacks to equivalence can be identified.[7] First, it is not risk sensitive, because it does not differentiate between individual market participants and does not measure the impact on investor protection and financial stability. Second, there is no provision that allows the European Securities Markets Authority (ESMA) to deny recognition of a specific market participant. This implies that once equivalence is granted to a certain jurisdiction, all licenced applicant participants from this jurisdiction should be recognised.[8]

Third, full reliance by ESMA on supervisory activities and cooperation with foreign (i.e. third country) regulators might entail an incentivised bias at a time of crisis. Should an emergency situation arise, would the foreign regulator put the interests of European investors and stakeholders before those of its domestic investors and other stakeholders? Fourth, ESMA has a limited monitoring capacity. Thus, while there is a need to enhance the equivalence regime, there is also a need to strengthen the supervisory powers of ESMA.

In order to avoid those drawbacks, the EC has recently reformed the third country regime for investment firms and central counterparties (CCPs), benchmarks and data service providers, strengthening the capacity of ESMA to oversee cross-border financial risks. However, ESMA is – and will continue to be – a secondary supervisor, mostly relying on the home regulator.[9]

UK and equivalence

When the equivalence regime was first introduced, it did not envisage the departure of a member state from the EU. In fact, nothing had been explicitly designed for a member state exiting the EU, as all the tools available are about bringing markets and economies together.

The EU-UK relationship is unique, with a high degree of connectivity between the two markets: the UK accounts for 93% of the share of interest rate derivatives trading in the EU, 84% of foreign exchange trading in the EU, 76% of euro currency trading in the EU, while 33-39% of equity trading in European indexes takes place in UK trading venues.[10] The question therefore arises whether equivalence is fit for the purpose of unplugging London from the rest of the continent, as well as how to solve some of the regulatory challenges brought about by Brexit.

With Brexit, Europe is facing a separation and therefore the need to adapt its equivalence framework. Nonetheless, the Political Declaration lacks substance regarding what equivalence might look like in the future.[11] On the one hand, temporary equivalence decisions such as those adopted by the EC on CCPs and central securities depositories (CSDs)[12] ensure continuity of services and reduce uncertainty for financial market participants. On the other hand, such decisions are not taking the uncertainty completely away as they are not widely applicable (e.g. MiFID trading obligation for shares and

[7] See EMIR Review Report no.4 of 13 August 2015.

[8] As long as the four conditions for recognition are met (Article 25(2) of EMIR).

[9] As of 1 January 2022, two new direct supervisory powers will start for ESMA: benchmarks and data service providers.

[10] But also other parts of the world provide an important source of liquidity in the EU ecosystem. For example, 75% of trading in German government bonds is with counterparties outside the euro area, and 61% of Euronext cash trading is intermediated by non-EU entities.

[11] See the Revised Political Declaration of 17 October 2019.

[12] For CCPs, Decision (EU) 2018/2031 and its extension Decision (EU) 2019/544. For CSDs, Decision (EU) 2018/2030 and its extension (EU) 2019/545.

derivatives), can be repealed,[13] are limited in time,[14] create cliff edges, contribute to regulatory short-termism, and might also be highly politicised.[15]

The March 2019 agreement on EMIR 2.2 is moving in the right direction as it tries to address issues related to proportionality in the application of rules (i.e. not every market/participant is the same, wholesale vs retail, systemic vs non-systemic) and risk sensitivity. The revised regulation divides CCPs into two tiers. While for non-systemically important CCPs (Tier 1) ESMA's powers do not 'materially' change,[16] for systemically important CCPs ESMA's powers have been significantly enhanced (i.e. direct supervisory power subject to EMIR rules). Moreover, for those systemically important CCPs for which ESMA deems that the Tier 2 regime does not sufficiently ensure the EU's financial stability, there is the possibility to require relocation to the EU27.

Even though relocation has attracted considerable attention, it has a liberal aspect to it, called 'comparable compliance'. This means that although a Tier 2 CCP is under the direct supervision of ESMA, it can request a finding that the rules to which it is subject in its home country are comparable to EU standards. In such cases ESMA steps back and there is deference to the supervision (e.g. deference to the rules from the third country). This might be an 'innovative' way of thinking about equivalence and potentially an interesting way forward.[17]

Whatever the final Brexit deal turns out to be, EU27-UK supervisory cooperation will have to grow and evolve over the coming years, perhaps under different frameworks and formulas. The recent agreement on the ESA Regulation simplifies the equivalence and third country access framework, as it moves third country recognition powers for certain market actors (i.e. financial benchmarks) from member states' national competent authorities (NCAs) to ESMA (and the other ESAs).

However, more needs to be done regarding the monitoring and reviewing of equivalence decisions. Equivalence is not only about comparing legislations and rulebooks, but also about supervisory outcomes and effective market supervision. The process should become more transparent regarding the criteria that feed into the assessment (e.g. is it purely a technical process or one linked to a broader economic relationship?).

The uniqueness of Brexit requires a much deeper connectivity, a much more profound relationship, and a full regulatory alignment between the EU27 and the UK. Having said that, the question arises of how equivalence can be maintained as an autonomous jurisdiction develops its regulatory framework. As the Political Declaration highlights, the EU and the UK will keep their autonomy, while

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[13] On 29 July 2019, equivalence decisions under the Credit Rating Agencies (CRAs) Regulation for Brazil, Canada, Argentina, Singapore and Australia were repealed, as the countries did not update their CRAs regimes to comply with EU law.

[14] On 21 December 2017, the EC granted recognition to trading venues in Switzerland as of 3 January 2018 for one year and extended it for a further six months. Sine 30 June 2019, equivalence expired and has not been renewed.

[15] The EC conditioned equivalence access for the Swiss stock exchange on a political agreement over the future relationship between the EU and the Helvetic country. When the Swiss Parliament refused to ratify the agreement, the EC decided to let the 'time-limited' equivalence decision in favour of the Swiss stock exchange to lapse.

[16] Although ESMA would be empowered to make information requests of all recognised CCPs and be required to assess the resilience of all recognised CCPs in adverse market conditions. See Moloney, N. (2018), "The Age of ESMA: Governing EU Financial Markets".

[17] On 11 November 2019, ESMA produced technical advice on comparable compliance and on the distinction of EMIR into core and non-core rules. This will mean that there is a tougher comparable compliance assessment for core and a lesser one for non-core CCPs. See https://www.esma.europa.eu/sites/default/files/library/esma70-151-2649_ta_on_comparable_compliance.pdf.

cooperating on a regulatory basis. In fact, being autonomous is not reflected in the power to legislate, but rather in the ability to control outcomes and respond to the fundamental needs of people.[18] And this is what equivalence does: it controls outcomes and responds to the needs of EU firms.

[18] See the speech by Mario Draghi on 22 February 2019: https://www.ecb.europa.eu/press/key/date/2019/html/ecb.sp190222~fc5501c1b1.en.html.