25th May 2020

The future relationship of the EU and UK in financial services
EBF view on the use of equivalence regimes

The ongoing Brexit negotiations on the future relationship will have a major impact on customers, businesses and citizens on both sides of the Channel. Irrespective of the outcome, the impact will not mean business as usual as the current situation where the UK is still part of the Single Market. Equivalence in the financial sector will most probably be a major tool for regulating interactions with third countries but will not replicate the benefits of Single Market membership. Against this background, the European banking sector calls on both sides to enable the development of the closest possible third country relationship with the UK, to ensure a level playing field and fair competition, to provide legal clarity, and to build the trust that is needed to maintain a mutually beneficial bilateral relationship.

The purpose of the current paper is to outline the banking sector's expectations for the future relationship in financial services, as well as providing views on how an equivalence regime could accommodate a mutually beneficial bilateral relationship between the EU and the UK, by preserving financial stability, market integrity, investor and consumer protection and fair competition based on a level playing field. While it is covered to a lesser extent in the paper, the UK's assessment of the EU's framework is as important as the EU regime. The following analysis presupposes a deal, the absence of which would raise a separate set of significant risks, which we analysed in 2019[1]. In this context, with the chance of a no-deal scenario still very high, we urge both parties to agree to an extension of the transitional arrangement before the end-June 2020 deadline to give all parties more time to reach a satisfactory agreement, especially considering the exceptional circumstances arising from the ongoing health crisis. In any case, the European Banking Federation calls on all its members and on banks to finalize preparations for the end of the transition period and to envisage all the scenarios possible.

I. Introduction

EBF members are committed to helping the European economy navigate through the difficulties posed by the global COVID-19 pandemic. To be truly effective, this effort requires close and intense coordination between public authorities and banks.

As the representative of the European banking sector, the EBF has actively participated in the Brexit process by coordinating the banks' preparations for different scenarios and by raising the EU's and the UK's awareness of the implications for the main stakeholders of the financial sector, i.e. corporates, investors depositors and other clients. The final shape of the bilateral relationship must serve the interests of people, businesses and economies in both the UK and the EU. We are pleased that some of our most serious concerns have been taken into account. While the financial sector has been considered by policymakers as relatively flexible and well-resourced compared to other sectors, the EBF and its members have consistently drawn attention to the fact that the relationship between the EU and the UK in the financial sector has potentially significant repercussions for the rest of the economy.

[1] EBF paper on application of WTO rules in case of no-deal available here

European Banking Federation aisbl

Brussels / Avenue des Arts 56, 1000 Brussels, Belgium / +32 2 508 3711 / info@ebf.eu
Frankfurt / Weißfrauenstraße 12-16, 60311 Frankfurt, Germany
EU Transparency Register / ID number: 4722660838-23

At the current stage, while Brexit itself has become a certainty, there is still a lot of uncertainty regarding the future bilateral relationship, the economies of both the UK and the EU countries and, in particular, the financial sector. It is highly probable that the EU's equivalence regimes will be used as a critical tool in implementing the politically agreed relationship.

II. Expectations of the European banking sector from the future relationship

As a starting point, the European banking sector recognises that, irrespective of the tools used to shape it, it would not be realistic to expect a relationship between the EU and the UK in the areas of financial services (or any area, for that matter) that contains the same level of market access as among members of the EU. Indisputably, as a third country, the UK will not retain the rights and privileges it had as an EU member. Consequently, the legal and regulatory conditions for market access between the EU and the UK cannot maintain the pre-Brexit level of openness and integration.

Moreover, the level of access will also clearly depend on the continuing level of regulatory alignment between the two sides, which could evolve in different directions overtime and have consequences for the future relationship in an area as heavily regulated as financial services.

Against this background and recognising these constraints, the banking sector still has the expectation that the relationship will be **as strong as possible,** to the mutual benefit of the economies and clients on both sides, especially in the short to medium term. One important motivation is the current level of cross-border business and mutually beneficial services. Although the United Kingdom has left the EU, the two respective financial systems are integrated like no others, due to more than four decades of EU membership and the work on the Single Rulebook for financial services. Both UK's households and corporates benefit from this close relationship.

The challenge for both the UK and the EU is how to create a framework that avoids abrupt disruptions in the short run and adapts to the medium-term needs of both sides while respecting the political constraints imposed by Brexit. This requires achieving the highest degree possible of certainty, stability, market access and regulatory cooperation through the reduction of the potential scope for regulatory arbitrage or hindrance of effective market oversight, while still respecting the **sovereignty and regulatory autonomy** of the parties concerned. Therefore, the EBF advocates an ambitious bilateral relationship based on mutual trust and a high degree of legal clarity, with a focus on the needs of the main stakeholders of the financial sector, i.e. corporates and households.

In this context, some lessons can be drawn from the 2019 FSB-IOSCO Report on market fragmentation, which documents the risks of fragmentation and makes recommendations on how to minimise it through reliance on international cooperation, including equivalence where possible. Unfortunately, the UK's decision to leave the single market will increase the fragmentation of cross-border services. However, in the **medium and long term**, the EU needs to move forward with its ambition to develop its own CMU which the EBF, together with other users and providers of services, has been promoting through the Markets4Europe campaign. In the meantime, significantly more needs to be done to reach a true Capital Markets Union; and both the EU and the UK need to focus on building an effective new relationship for capital markets in Europe to continue working as effectively as possible in the foreseeable future.

III. High-level principles to guide the evolution of the EU's equivalence regime

Interactions in the field of financial services will be mainly regulated via the EU's (and the UK's) equivalence regime(s). That is why it is necessary to analyse how the EU's existing equivalence framework would apply to the EU-UK relationship (as to any other country).

The EU's equivalence regime, namely a process whereby the European Commission assesses and determines whether a third country's regulatory, supervisory and enforcement regime is equivalent to the corresponding EU framework, is a useful tool used at the discretion of the EU Commission[2]. The equivalence regime has three important features when it comes to its potential use in the EU-UK relationship:

1) it was designed to accommodate an economic relationship that was much less integrated than the relationship between the EU and the UK, and it was not designed for countries with a high degree of regulatory alignment at the start of the equivalence assessments;
2) it was designed for countries willing to remain aligned and committed to maintaining such regulatory alignment over time;
3) the scope of equivalence is more limited than the EU rules as they applied to the UK as an EU member and would create only a limited area of market access. Indeed, most equivalence decisions bring prudential benefits, e.g. avoiding duplicative requirements; and some equivalence decisions provide market access.

Certain aspects of the process and scope of the equivalence regime had already been the subject of calls for improvement, long before Brexit. The end of the transition period represents an opportunity to reflect upon the current EU equivalence regime and to consider any possible development to pursue in the future, beyond the current assessment of the UK.

• Main advantages of the current equivalence regime

Despite the drawbacks outlined above, there are aspects of the framework that must also be preserved:

- ✓ it ensures the **autonomy** of the EU decisions and continued supremacy of EU law over Member States rules; the EU remains sovereign and maintains the integrity of the Single Market;
- ✓ it includes a thorough **technical assessment** and involves, where necessary, the supervisory bodies; the ESAs indeed have a prominent role to play by providing technical input and by monitoring further developments likely to affect the equivalence decisions granted;
- ✓ it allows for the withdrawal of equivalence on a **unilateral** basis in order to maintain high regulatory standards and manage risk.

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[2] The equivalence assessment does not mean that the third country regulatory and supervisory framework is 'identical' to the EU framework.
https://www.europarl.europa.eu/RegData/etudes/IDAN/2018/614495/IPOL_IDA(2018)614495_EN.pdf
https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/190729-communication-equivalence-financial-services_en.pdf

- ## Recommendations regarding possible improvements of the current regime

The EBF believes that – in line with the European Commission's efforts[3] as well as the recent developments taking place at legislative EU level[4] – further improvements to the current regime are necessary to facilitate open capital markets and foster relations between the EU and third countries, including the UK.

1) Provide flexibility to accommodate countries with greater regulatory alignment

While the EU's equivalence regime cannot be tailored to different countries, it can provide room for taking due note of the level of alignment of the countries. International standards

(e.g. FSB, IOSCO, BIS, BCBS, FATF) should play a more important role in the future EU-UK relationship and should receive due attention in the equivalence regime. In this context, the broader implications of equivalence, especially on the relationship with the US, should not be underestimated[5]. A forum for EU-UK regulatory dialogue and supervisory cooperation would help avoid some unnecessary pitfalls of fragmentation. The FSB-IOSCO Report referred to earlier recommends, amongst others, to: 1) consistently implement international standards; 2) coordinate timing of implementation of international rules (to prevent overlapping or contradictory rules); 3) align on data and reporting rules; and 4) allow, where appropriate, firms to defer to home rules.

2) Make the regime more transparent

The EU already has in place good practices about transparency, with, for instance, a public consultation of stakeholders before adopting or withdrawing equivalence.

At the same time, one could look for ways of increasing the transparency of the process, timelines and assessment criteria[6], without taking away the EU's ability to reach autonomous decisions in line with its objectives.

The assessment criteria should be based on a rigorous case-by-case assessment of a third-country rules and supervisory framework. The assessment criteria should be made available to third countries so that they are able to adapt their local legislative and regulatory framework to meet the EU requirements. Transparency on the various steps of the process, and the possibility for the industry to be consulted in the process should be taken into consideration.

[3] EC Communication of July 29, 2019

[4] For instance, the regimes dedicated, respectively, to Third Country CCPs enshrined in EMIR, as amended by means of the EMIR II.2. Regulation, and to Third Country investment firms under MiFIR, as amended in the context of the so-called Investment Firm Review)

[5] EMIR 2.2 and the equivalence of US CCPs is a clear example of that

[6] In its Report on Market Fragmentation and Cross-border Regulation, IOSCO has highlighted a) the lack of clarity about the assessment criteria from the perspective of the jurisdiction being assessed b) the lack of clear processes and procedures, including in the review of whether to revoke a positive recognition decision, noting i) that this is particularly true, if there no procedures in place, to mitigate the impact of a review and ii) that this could also lead to a perceived lack of consistency iii) and the lack of a clear timeframe for making assessments that can create risks of competitive distortions in the market.

A more transparent process would however neither limit nor preclude the EU's decision-making autonomy, a fundamental value recognised by the EU treaties. The same principle should apply to the UK's autonomy.

3) Improve predictability and clarity

The banking sector stands ready to adapt and adjust in a timely manner in accordance with any EU decision. Predictability and clarity of such decisions help banks and financial institutions to keep serving their clients' interest in a satisfactory way. This also provides market participants with enough time to prepare and, thus, contributes to financial stability.

Regular review, based on clearly defined criteria, could be made up of several steps and each step could stand as a milestone on which market players could rely, in order to assess the likelihood of a possible withdrawal, should the European Commission consider that the third country's rules no longer comply with the EU's.

We would then encourage policymakers to provide market participants with timely guidance and accompany any removal of equivalence with appropriate transitional measures and adaptation periods which would help to strike the right balance between the necessary autonomy of the EU and avoid cliff edge effects.

4) Equivalence decisions deemed necessary in the short term

Since a trade agreement will probably only address high-level principles, the EU must prioritise a set of equivalence decisions necessary in the short run. This is especially urgent given the aim to conclude equivalence assessments by 30 June 2020.

The EBF believes that, in a number of areas, it is urgent to start the procedure for issuing equivalence decisions in order not to disrupt the efficient provision of services to the clients of the banking sector, after the Withdrawal Agreement transition period. The UK should commit to remaining aligned with EU rules and ensuring proper oversight by EU authorities as necessary.

Based on a technical analysis conducted by the EBF members, below is a list of the areas of activity for which an equivalence decision is **urgent**:

- **clearing and CCP location policy** (EMIR) until the entry into force of EMIR 2.2; the equivalence of UK CCPs is essential, not only for EU clearing firms and other financial institutions, but also for EU corporates and the real economy, as they will need continuous access to UK liquidity pools that do not have an EU alternative;
- **securities and derivatives trading venues** (MIFID/MIFIR);
- **Capital Requirements Regulation** (CRR);
- **post-trading custody and settlements operations and infrastructures** (CSDR); Central Securities Depositories (CSDs) are fundamental Financial Market Infrastructures, along with CCPs, and deeply inter-related with them[7].

In the absence of EU equivalence decisions, diverging national solutions may arise, with the risk of regulatory arbitrage and forum shopping. Such divergence would worsen market fragmentation, impact EU competitiveness and limit the ability of EU players to fulfil clients' needs as they would face unfair competition from arbitraging firms.

[7] In December 2018, the EC issued temporary equivalence decisions on CCPs and CSDs; Bank of England is also periodically updating an Interim list of third-country CSDs that intend to provide their services in the UK using the transitional provisions of the "Central Securities Depositories (Amendment) (EU Exit) Regulations 2018".

More details are available in the attached annexes.

IV. Expectations from the UK’s Assessment of the EU’s Framework

In line with the expectations outlined above, the European banking sector expects from the UK a constructive approach that allows the building up of the trust needed to create a relationship adapted to both the short-term and longer-term interests of the stakeholders on both sides.

Of particular relevance, is for the UK to commit to an equivalence regime that will apply to the EU the characteristics recommended above, i.e. one that preserves financial stability, market integrity, investor and consumer protection, as well as fair competition based on a level playing field. Such a regime should be transparent and predictable, as it should be for the EU, and help market participants maintain the closest possible relationship.

As the ability and intention of third countries to diverge can have a strong impact on how such relationships with the EU can be built and developed, a potential regulatory divergence of the UK from EU rules is likely to jeopardise a new relationship. As the banking sector, we recommend that both parts, and in particular the UK, maintain a constant dialogue with its counterpart and remain aligned as much as possible to a common set of rules, which would not only ensure a constructive long-term cooperation and legal certainty, but also serve the interests of banks and customers of both sides of the Channel, more effectively.

Annex 1: First Priority Areas regarding equivalence decisions

- **Art. 33 MIFIR - Derivatives: trade execution and clearing obligations;** third-country trading venues can be accepted to fulfil the requirements for trade execution and clearing obligation on derivatives.
- **Art. 38 MIFIR - Access to the EU for third-country trading venues and CCPs:** third-country trading venues and central counterparties ("CCPs") recognised under EMIR may be permitted access to EU CCPs and trading venues.
- **Art. 25(6) EMIR – CCP recognition:** CCPs' procedure for recognition of central counterparties ('CCPs') established in third countries.
- **Art. 107(4) CRR - Credit institutions /investment firms/ exchanges:** allows institutions to treat exposures to third-country investment firms, credit institutions and exchanges, as exposures are similar to those of the EU financial institutions.

Annex 2: Non-exhaustive List of Areas regarding equivalence decisions

MIFID/MIFIR

- **Art. 1(9) MIFIR - central bank exemption:** transactions with central banks from third countries can be exempted from the scope of the regulation (in the same way as transactions with the European System of Central Banks).
- **Art. 23 and 28 MIFIR - Obligation to trade shares and derivatives on regulated markets:** third-country trading venues may be considered as regulated markets for the purpose of these articles.
- **Art. 25(4) MIFID II - Assessment of suitability and appropriateness of clients:** a third-country market can be assessed equivalent to a regulated market to appreciate whether financial institutions have to enquire about a person's knowledge and experience in the investment field.
- **Art. 33 MIFIR - Derivatives: trade execution and clearing obligations:** third-country trading venues can be accepted to fulfil the requirements for trade execution and clearing obligation on derivatives.
- **Art. 38 MIFIR - Access to the EU for third-country trading venues and CCPs:** third-country trading venues and central counterparties ("CCPs") recognised under EMIR may be permitted access to EU CCPs and trading venues.

CRR/CRDIV

- **Art. 107(4) CRR - Credit institutions /investment firms/ exchanges:** allows institutions to treat exposures to third-country investment firms, credit institutions and exchanges as exposures are similar to those of the EU financial institutions.

- **Art. 114, 115, 116 CRR - Exposures to central governments, central banks, regional governments, local authorities and public sector entities:** the specific risk weights applicable to exposures to central governments, central banks, regional governments, local authorities, and public sector entities may apply to similar entities located in third countries for the purpose of calculation of the capital ratio of EU financial institutions.
- **Art. 142 CRR - credit institutions/investment firms:** a subsidiary located in a third country can be taken into account when defining 'large financial sector entity'.
- **Art. 391(2), 395(2) CRR II - Institution/shadow banks:** for the purposes of the large exposure regime undertakings, authorised in a third country - which apply prudential supervisory and regulatory requirements, at least equivalent to those applied in the Union - they are treated as "institutions" and not as "shadow banks".

CSDR

- **Art. 25(9) CSDR:** Equivalent system for the recognition of CSDs authorised under third-country legal regimes.

EMIR

- **Art. 1(6) EMIR - central banks:** transactions with central banks from third countries can be exempted from the scope of the regulation (in the same way as transactions with the European System of Central Banks).
- **Art. 2a EMIR - regulated markets:** defines when a third-country market is considered equivalent to a regulated market.
- **Art. 13 EMIR - clearing, reporting, risk mitigation and margin requirements:** third-country regimes can be considered as equivalent to avoid complicating or having conflicting rules on financial transactions.
- **Art. 25(6) EMIR – CCP recognition:** CCPs' procedure for recognition of central counterparties ('CCPs') established in third countries.
- **Art. 75 EMIR - trade repositories:** third-country trade repositories can be recognised as equivalent to be able to conclude international agreements for the exchange of information on derivatives contracts.