Professor Danuta Hübner, Ph.D.
Chair of the Committee on Constitutional Affairs
in the European Parliament

Equivalence and its impact on the financial sector

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I would like to comment on three issues. First, on the concept of equivalence, based on existing provisions in EU legislation. Then, on the ongoing discussions regarding equivalence. And finally, on the ongoing changes to the approach to equivalence that we have been seeing recently in the context of Brexit. And I should also make it clear at the beginning that financial firms can of course register in the EU or they can establish their own entities. And what goes without saying, different rule books normally lead to regulatory competition and the risk of regulatory arbitrage.

Let me first touch upon the concept of equivalence. The European Union has developed it over time in order to regulate its relationship with third countries as regards financial services. It basically means that firms established in a third country jurisdiction will be able to access the EU market and serve clients established in the Union. The precondition is that those firms are established in a jurisdiction the framework of which (that is, both the legal framework of the jurisdiction and the way supervision is exercised there) has been recognised as “equivalent” to the EU framework, that is, achieving the same outcomes as the EU framework.

Provisions granting equivalence are to be found in tens of Union legal texts such as EMIR, the regulation on central securities depositories, the regulation on credit rating agencies, the SFT regulation, UCITS, AIFMD, MiFiD and others. The European Commission has issued about 200 equivalence decisions concerning around 30 jurisdictions.

The equivalence process is a standard one. The Commission checks the framework of the third country jurisdiction, adopts an implementing act declaring the framework as equivalent and then, once the act is adopted, the relevant European Supervisory Authority (ESA) may assess and then recognise the businesses that come from this jurisdiction and authorise them to provide services in the Union. Equivalence can be withdrawn by the Commission. It is therefore a unilateral process, based on clauses

that exist in each piece of legislation. Then, typically, when equivalence is granted, supervision will rely on the arrangements with the third country and equivalence will be regularly monitored by the relevant ESA.

The goal of the various equivalence regimes is to allow the Union to be open to financial services providers from the outside while avoiding the exposure to excessive risk and creating opportunities for arbitrage. Market access is only granted to firms established in a jurisdiction where we can be sure that the firms will not bring undue risk to the Union.

Overall, the experience with equivalence so far has been positive for the EU and also for its international partners. There has been no complaint from the major non EU financial centre, the US, that equivalence prevented them from being as active as they wanted in the Union.

In the context of Brexit, fundamentally important conditions for the financial services solutions belong to the three red lines, the three “noes” which imply the possibility of departing from the EU rules and not being under the ECJ judicial control. One cannot at this stage entirely exclude the possibility of developing by the UK a double rule book but the red lines say something different.

The perspective of Brexit has made equivalence an important point in the debate on the future relationship between the UK and EU. The need has emerged to look anew at equivalence regime from the perspective of risk exposure and financial stability of the European Union on the one hand, and the potential to improve the regime on the other.

In this context four issues are worth pointing at.

First, equivalence is recognized only in some areas, envisaged in the European legislation. Certain areas, like deposits, are not covered by equivalence. This might mean that, after Brexit, some activities might have no equivalence regime.

Then, equivalence is based on a regulation-per-regulation approach. It is not horizontal. While there are good reasons for this, as each industry has different needs and a different concept of equivalence, this situation makes it complicated to address the situation created by Brexit, where tens of separate equivalence decisions will be needed.

Thirdly, the decision by the European Commission to grant equivalence to a third country is an arbitrary, unilateral decision, proportionate, which can be easily withdrawn. It is always risk based and case by case. This of course does not create the certainty that the partners of the Union would wish.

Under some pieces of legislation (e.g EMIR) equivalence, once it is granted, implies a lot of reliance on third country supervisors for the supervision of third country entities. That brings additional challenges if a large market such as the UK is involved and might clearly remain a major partner for our providers of financial services and consequently, if the actions taken in the UK will keep affecting EU markets.

In the reflection on the future EU-UK framework that could best cover financial sector requirements the possibility of using the free trade agreement framework has been coming back and forth. This possibility has been strongly rejected by the EU side in the negotiations. Also, in the context of the mutual recognition element in it. This framework has not been seen as an adequate one, except for the right of establishment component which is about the commitment to give a firm the right to establish itself in a member state to provide services to the EU. In case of Brexit that would mean that there would be no access from London and firms will have to set up subsidiaries in the EU.

Chancellor Hammond asked in March why, if financial services could be included in a deal with the US and Canada, the same could not be done with the UK. But, actually, with the US, this was not done, and in CETA there is only a small chapter on financial services, dealing mostly with establishment and with the mechanism of prudential carve out.

When we look at how much of our financial cooperation can be covered by the free trade framework we have to remember that the EU framework for financial services is about the single market, integrated, providing financial stability, protecting consumers, providing a level playing field, deeply regulated, based on single rulebook and strictly supervised, with crucial role of European supervisors promoting convergence. All that does not come within a free trade framework.

Another option that we have been hearing from the UK side, the industry of course (we had a report from the International Regulatory Strategy Group, and a report from

Barnabas Reynolds) but also Mr Hammond and Mrs May and which has been debated in the European Parliament in the context of draft report of Brian Hayes on equivalence, is the “mutual recognition” approach. Judging upon some statements of the British politicians, one can understand that the UK wants to keep regulatory autonomy with a commitment to achieve equivalent outcomes.

With some variants across the different proposals, the idea would be to have a hybrid model, governed by some international agreement that would give the UK freedom to set its own rules while still retaining access if standards across the UK and EU were aligned. The UK would maintain “substantially similar” standards, which would be either the same in substance or outcome. Access would then be restricted only if and when the UK or EU decide to diverge significantly. The model would provide a system for both sides to discuss rules changes and handle disputes.

This approach has not gathered support from the EU. It raises indeed a series of concerns.

The main concern relates to the regulatory autonomy of the Union. An agreement in which we would agree in advance on the common outcomes to use in order to grant and maintain equivalence or in which we would agree to be bound by some international standards that the Union has a limited power to shape would reduce the ability of the Union to set its rules independently. It would mean serious, permanent constraints on the EU and even expose the Union to potentially serious stability issues as rule taker. It would amount to recognise the regulatory and supervisory system of the third country, de facto emptying EU rules and EU supervision. Neither the single rulebook, nor the integrated supervisory system that we have created would apply anymore, which would create important risks for regulatory and supervisory arbitrage.

Then, there are some more practical issues raised by mutual recognition approach. I would see two of them. First is the question of what we really use to monitor divergence. It is not at all clear what a satisfactory yardstick should be. If we agree in advance on what the outcomes to be achieved will be, this might make the system very inflexible for both parties. In addition to the regulatory autonomy issue I mentioned, there is a more practical problem that the agreed outcomes might

become at some point obsolete or no longer suited to an emerging new situation, so we need at least ways to review them.

If, instead or as a complement, we use international standards as an equivalence test, then there is another set of potential problems.

Those standards do not exist in all areas, and certainly are not at the same level of detail in all areas. They are also typically and on purpose broad enough to leave a wide scope for divergence. They are, in addition, rather minimum standards. This creates a problem to assess whether the EU and a third country diverge in areas where the Union has gone further than international standards. Which the Union has an inclination to do.

Also, we all would like the assessment of whether or not divergence has occurred and recognition can be granted or maintained to be a technical assessment. The issue there is that in practice, the vaguer the rules used as a basis for the assessment, the higher the risk that the assessment will have some element of subjectivity in it. It is not a problem per se, but it is a reminder of the need to have very clear rules.

The second area of practical concerns relates to the effectiveness of the system to be set up in order to monitor convergence and possibly settle disputes.

From EU history, we know only too well how difficult it is to create supervisory convergence within the Union. And this in the situation where there are EU level supervisory authorities and a common rulebook. This could be unmanageable for a multilateral system.

A more specific concern in that regard is that procedures for dispute handling and possible withdrawal of recognition might be too lengthy for any party to take effective action. It might take a lot of time to withdraw equivalence in case divergence arise and become too wide, and this might not enable a party to react to a threat to financial stability caused by a regulatory divergence and to protect itself effectively.

This is why all the signals I receive indicate that the Union is very much intending to use equivalence as a basis for the future relationship between the EU and the UK. Mutual recognition will continue to be seen through the perspective of undermining autonomy of rule-making and integrity of single market.

It is true that equivalence has the advantage of safeguarding the autonomy of the EU decision-making since it is designed and implemented unilaterally by the EU. But this does not exclude reciprocity requirements where needed.

Equivalence has also historically helped promote regulatory convergence around international standards. I can see from the EMIR that equivalence arrangements can be a major trigger for establishing and upgrading supervisory co-operation, while maintaining the autonomy of decision-making of the EU.

Can equivalence be addressed through an omnibus type of legal act on equivalence is also a question to raise. We know that the European Commission has dedicated some time to reflect on a horizontal legal act that would establish a single framework for equivalence procedures to replace the current equivalence provisions scattered in many pieces of legislation. The Commission has acknowledged that this option has been looked at and that it might look at it again. Nevertheless, it points to some concerns with such a horizontal approach. The main problem is the sheer diversity of the nature and objectives of the various equivalence provisions. As I said previously, the needs of each industry, and the way each industry sees the concept of equivalence are different, and they might simply be too different for an omnibus piece of legislation on equivalence to be adopted. The Commission also considers that an omnibus act on equivalence might create too rigid procedures and make discussions on the assessments and the terms of equivalence with regulators in the third country more difficult.

So, to conclude let me say that there will be the need to look seriously at the potential of regulatory and supervisory cooperation. There will be the need to build a coordinated approach to shaping and implementing international standards. But this is not about mutual recognition. EU will not change its regulations which give certain rights only to the EU member states and the EEA. EU will have the right to revoke the equivalence decisions. So, as I have been always saying during our meetings, your reflection should go toward how to make equivalence more business friendly, in particular, when it comes to its withdrawal and push regulators and supervisors toward more comprehensive dialogue.