SESSION SUMMARY - HELSINKI SEPTEMBER 2019

Enhancing financial policies dealing with third-countries

The objective of this session was to assess the positive features and areas of improvement of existing EU third-country regimes in the area of financial services and how issues may vary for different activities and jurisdictions. The panel also discussed the improvements that could be made to EU equivalence regimes, their feasibility and how proposals made at the EU and global levels can be taken on board.

1. Strengths of existing EU third-country arrangements

A policymaker stated that the European Commission sees equivalence as the key instrument going forward for managing EU trade relations in the financial services sector. Equivalence is appropriate because it opens EU markets to third country providers but also allows the management of the risks that may be created by this access. The regime also facilitates market interaction, while allowing each jurisdiction to retain its autonomy. Finally, it is quicker for the Commission to deliver than a bilateral agreement would be. In economic terms, the upsides of equivalence are that it promotes competition in the European market and reduces compliance costs for the industry, while helping to mitigate risks.

An official agreed that the European regime addresses the different dimensions of equivalence (i.e. access, prudential treatment…). A further strength is that it is considered for each sector or activity as legislation is drafted. Many firms are concerned that the EU approach to equivalence differs across legislations, but this also means that the particular issues of each legislation with regard to third countries are addressed specifically. In addition, these arrangements are put in place through a fairly transparent process of negotiation.

A market observer emphasized that from the point of view of the users, equivalence reduces overlaps and facilitates compliance with regulatory requirements. The openness of the regime and the competition it creates however require significant supervisory and regulatory cooperation.

2. Weaknesses of existing EU third-country arrangements

2.1. Insufficient predictability

An official stated that although the risk of withdrawal of equivalence is an extremely rare tail event it causes major anxiety to the industry and will continue to be a challenge, as equivalence regimes are developed and are used. That anxiety may undermine the viability of equivalence as a structure for trade if it is not appropriately addressed. The withdrawal of equivalence in the summer for certain third-country jurisdictions in the field of credit rating agencies (CRAs) was much less disruptive than might have been expected, but this might not always be the case.

A policymaker acknowledged there are some downsides for third-countries to the EU equivalence regime, such as the possibility of withdrawal but this is a risk mitigation tool inherent to the regime. The possibility to withdraw equivalence leads people to say that it is uncertain, but this potential risk is overstated. EU countries indeed benefit from opening their markets and before July 2019, the Commission had never withdrawn an equivalence decision. The withdrawal that happened in July concerned the CRAs of five jurisdictions that decided not to implement legislative adjustments to the CRA regulation given the scope of activity to be covered. This had been discussed and prepared with those jurisdictions a long time ahead.

Another official reiterated that equivalence regimes should not be seen as a pure trade tool. There is a debate about the European Union being open or closed with these regimes, but it is not the right one. By definition when you have a third-country regime it is because you want to be open, but you also need to be able to monitor and master risks, which is why some conditions are needed for jurisdictions to be deemed equivalent. Financial activities may have major social or economic consequences for the EU if there is a failure of risk management or supervision in a foreign country, therefore there is a need for appropriate safeguards. The European Union is accountable for putting these safeguards in place within the equivalence regime.

A market observer stressed that the most important safeguard for the EU in terms of risk mitigation is that equivalence is a unilateral decision that can be repealed. If equivalence was granted forever then the EU might completely lose control of its financial stability risk or be obliged to follow the rules of dominant jurisdictions that have large shares of certain financial markets. The EU needs to be able to decide which activities and entities can operate in the EU and those that should be left outside.

2.2. Possible politicisation

An official noted that the possible politicisation of equivalence processes is another concern. The decision regarding Switzerland for share trading raised many questions about the operation of equivalence and how these systems may be applied to the UK in the future. That is a reputational challenge for this system that will be in people's minds as the UK leaves the EU.

A regulator considered that the political dimension present notably in trade 'disagreements' undermines the attractiveness of and trust in these regimes. The withdrawal of equivalence for Switzerland regarding share trading for example has led to a classic 'tit for tat' situation that has resulted in a lose lose scenario for open markets and a loss of liquidity. The more third-countries have the feeling that there are overarching considerations that will dominate the decision that has been technically prepared, the less they will be ready to invest in going through this process in the future.

Another regulator stated that equivalence decisions and assessments need to be transparent and technical in order to make appropriate decisions on whether to give access to the EU market and whether this will support the global financial markets. At the same time one should not be naïve. These decisions can be part of broader political negotiations in certain circumstances. In the case of the Swiss share trading obligation it was quite clear from the communication of the Commission that the decision was part of a broader discussion related to the framework agreement between Switzerland and the EU. For both the Swiss and the EU this ended up being a negative sum game and fragmented markets. Ultimately, the financial markets were not better off in this case.

In addition, a policymaker explained that it is always possible to consider that not granting or withdrawing equivalence for any reason that does not directly relate to the regulation of that sector could be a politicisation. However it is not that simple. Equivalence

decisions have to take into account a wider context to ensure an appropriate mitigation of risks. For example, if the Commission does not think that the anti-money laundering regime of a given country is right, this cannot be ignored.

2.3. Time-consuming and uncertain process

A regulator considered that another issue with equivalence is the complexity of the assessment and decision-making process. The time investment for a smaller jurisdiction in operating these processes is enormous. The EU financial market is extremely complicated, with approaches that vary across member states. The process is also very painful with a number of turgid documents and evaluations to go through and a result difficult to anticipate until the last moment.

Another regulator stated that the EU has no desire to make this process painful. The supervisors in charge are just doing their best to verify that the conditions for keeping EU markets open are met. Access to the whole EU internal market provided by equivalence is a 'big prize' to obtain, as this takes away a significant part of the effort that would otherwise be needed to obtain a licence in all 28 member states, which is the base case in most other jurisdictions. For instance, there are at present 34 third-country CCPs that are recognised following equivalence decisions taken by the European Commission on the basis of a relatively quick process at ESMA and thus have full access to the European derivatives markets. It is fair for the EU to make sure that this full access to that part of the EU financial market does not result in importing excessive risks, which involves having sufficient information on potential risks and being able to evaluate whether they can be mitigated.

3. Changes potentially required with Brexit

An official felt that one concern with equivalence is that some measures have only been tested on a limited number of occasions, which makes predictability difficult. That should change with the UK leaving the EU, which will be the most demanding test for this approach so far, because of the scale of the EU-UK trade relationship and the impact of potential regulatory divergences in the future. Another issue is the degree of informality of present equivalence processes based on informal MoUs for example. The equivalence measures in the acquis will probably need some expansion over time for the relationship with the UK, with more formal equivalence assessment processes and the setting up of a structured cross-sectoral EU-UK dialogue to support equivalence between the two jurisdictions. This could potentially be replicated for other jurisdictions.

The official then described the main factors of success of an equivalence approach with the UK. First an unprecedented degree of supervisory cooperation, formal and informal, will be needed to make it work. That is how it works at present, with the UK part of the single market. When the UK leaves the EU this level of cooperation will need to be maintained because there will still be a great deal of flow happening between the UK and the EU despite the frictions and barriers that may develop. Secondly, this process needs to be robust, which means that the decisions need to be defensible and the cooperation arrangements must be 'supervisable'.

A regulator emphasized that with the UK leaving there can be situations where market participants from outside the EU pose specific risks to the EU. It would be wrong from an accountability perspective for the EU to completely rely on the third country regulator and supervisor in that case. As a member of the single market, UK regulators currently provide the rest of Europe with information on UK based market participants. If in the future this access to information is reduced, EU supervisors will no longer be able to make sure that risks posed to the EU27 are properly assessed and can be acted upon. These issues would be increased by any divergence between EU and UK regulatory systems in the future.

A market expert felt that if equivalence is pushed to the extreme there is also a risk that the EU might end up completely relying on a third country, the UK or another, for some segments of its market. That is only viable if there is a high degree of regulatory alignment and if supervisory cooperation works well, as is the case at present in the EU. In the future, if one of the jurisdictions decides to change its regulation e.g. lowering its rules or if supervisory cooperation does not work so well, it must be possible to withdraw equivalence if this poses excessive risks to the EU. A withdrawal of equivalence would however create major disruptions for the users in this case. Ensuring that there is an acceptable balance between the activities that take place in the home jurisdiction and those that are provided from third countries through equivalence is therefore important in terms of managing risk in the long term.

A policymaker agreed that intensive regulatory dialogue will be necessary with the UK in order to anticipate potential problems as upstream as possible and with enough time left for addressing potential problems. This is however easier for regulatory than for supervisory issues.

4. Suggestions for improving EU equivalence processes

4.1. Towards a more global approach to equivalence arrangements

A regulator highlighted the problems stemming from the design of equivalence processes, when considering them in a global perspective. If a country is a third country to every other financial market in the world and vice versa this will lead to a very 'baroque" architecture, which will become increasingly complicated as the financial market becomes more multipolar. Expanding networks of bilateral equivalence designations will also be extremely time-consuming to put in place and manage. It is uncertain whether the complicated bilateral matrix this will result in is really operable and whether all these bilateral agreements are generating added value for their constituencies. A different type of design should be thought of, leveraging the global standards and assessment processes that exist in many areas of finance.

An official added that the idea of a more global perspective to equivalence beyond individual jurisdictional interests is gaining attention at the international level with events such as the UK leaving the EU, the growth of financial markets in Asia and also the emergence of new kinds of products, services with risks that must be regulated in a coherent way across jurisdictions. A regulator added that more international cooperation would also help to optimise the use of supervisory resources which are scarce.

Another official acknowledged that using global standards and common processes defined at the international level could help to simplify equivalence assessments and added that efforts should be made to ensure that European legislation is understandable for third-countries. However, relations based on equivalence should remain bilateral rather than multilateral, the official believed. Jurisdictions should be accountable and remain sovereign in using equivalence tools and should be free to withdraw equivalence if necessary.

A market expert moreover emphasized that international standards are more developed in domains where the equivalence regime is not applied, such as banking supervision and regulation and less so in the capital markets. A regulator noted that data is another important area where there are no equivalent solutions.

An industry representative was in favour of equivalence processes, which can help to narrow down cross border divergences and incompatibilities of regulations and considered the EU's process as one of the most advanced. This bilateral process, which is quite time consuming and relatively slow with all the parties involved asked to produce separate questionnaires and conduct individual equivalence assessments could however be improved with further coordination between the parties involved and a reduced number of individual equivalence decisions.

The speaker outlined the example of a significant effort being made in Asia to make the equivalence process more efficient. In October

2016 the Japanese FSA launched the so called 'platform for equivalence assessment' in order to evaluate the equivalence of OTC derivatives margin regulations with the authorities of Australia, Hong Kong and Singapore. This platform aims to enhance mutual understanding, make the assessment process more efficient and streamline the approval process. A single questionnaire was used to collect all the information, outstanding questions were addressed collectively and there was a mutual agreement on the equivalence decision with an aligned timing of publication.

The EU is moving in a similar direction with the establishment of coordination groups, which should improve alignment within the EU in the future. The EU equivalence process could however better take into account international standards and be further standardised with a global perspective, the industry speaker believed. Continuous regulatory dialogue is also essential at the global level to help alleviate the effects of current fragmentation trends illustrated e.g. by the ring fencing of activities or initiatives around bank liquidity and capital, such as intermediate parent undertakings (IPU).

A regulator felt that this initiative underway in Asia shows that within the 'bilateral world' a more multilateral process, based on common sources of information and evaluations, can be used to make assessments simpler, shorter and more predictable.

A policymaker agreed that a more multilateral approach to equivalence would be desirable. However following the financial crisis, risk tolerance and trust among supervisors have diminished within the EU and at the international level. Less burdensome approaches should nevertheless be sought.

4.2. Improving risk monitoring

An official considered that the monitoring of financial risk in the context of EU equivalence arrangements could be improved. This involves first a systematic check of existing equivalence arrangements from a risk perspective on the occasion of reviews. Secondly, there may be a need to provide more gradual answers than the current 'black and white' system of equivalence / withdrawal, particularly in areas where there are significant flows of business and where a withdrawal may lead to a difficult cliff edge. The EMIR 2.2 process adopted for clearing houses goes in the right direction, the speaker believed, with a tiering approach depending on the magnitude of possible risks. Some aspects of the recent investment firm review are also interesting to consider, such as the information about the proportion of business done in the EU. The trust of third-country counterparts in EU equivalence regimes could also be improved, with more predictability and transparency. Some common principles could be established, with more explicit criteria for granting and withdrawing equivalence and an enhanced dialogue involving the ESAs. A horizontal equivalence system does not seem appropriate however, since risks depend on the market segment considered,

A regulator agreed that at more gradual equivalence system is necessary. The present system with full reliance on a third-country supervisor can be maintained when there are no specific financial stability issues. But if there are financial stability concerns for the EU then the equivalence system needs stepping up with direct supervision and a more granular assessment of regulations, as has been done in the context of EMIR 2.2. A market expert also concurred with the suggestion that a greater clarity of requirements for granting equivalence is needed, as well as more predictability. Decisions made must be understandable and consistent. Equivalence arrangements must also be robust, which requires effective monitoring, regular assessments and on-going discussions between the jurisdictions concerned. In addition, the EU must ensure there is reciprocity, which goes with the openness of the equivalence approach towards third-countries.

Another regulator suggested that equivalence assessment processes should be more risk-oriented and less focused on the letter of the law. A detailed literal examination of regulations increases the burden and may ultimately miss the objective, which is to ensure that there is no regulatory arbitrage or a race to the bottom between jurisdictions so that business can easily move between them. The way regulations are supervised is also essential and may have more effect in the end than the way they are drafted. Assessing supervisory effectiveness is however not easy. It needs to be based on an evaluation of whether the main risks are covered in an appropriate way and whether this is likely to continue in the future.

A regulator considered that the equivalence decisions that have been made by the EU were quite outcomes-based and did not go into a line-by-line comparison. A policymaker noted that what is precisely an outcomes-based process is not easy to define. An international resolution to determine this would be helpful.

Speakers

Chair

David Wright
President, EUROFI

Public Authorities

John Berrigan
Deputy Director-General, DG FISMA, European Commission

Katharine Braddick
Director General, Financial Services, HM Treasury

Mark Branson
Chief Executive Officer, FINMA

Steven Maijoor
Chair, ESMA

Sébastien Raspiller
Assistant Secretary, French Treasury,
Ministry of Economy and Finance, France

Industry Representative

Takanori Sazaki
Regional Executive for EMEA, Mitsubishi UFJ Financial Group

Expert

Christian Noyer
Honorary Governor, Banque de France