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Optimizing third-country approaches in the financial sector: the challenges of Brexit

Progress of EU-UK trade negotiations

The Brexit timetable is now more clearly set out following the conclusion of the withdrawal agreement between the EU and the UK, which entered into force in February 2020, opening the way to a transition period until the end of 2020 during which the current situation will be maintained. Although the terms of the withdrawal agreement mention that the UK may decide in June whether to request an extension to the transition period until the end of 2021, a UK law has already been passed ruling out any extension[1].

The terms of a potential trade deal that would govern future EU-UK trade relations after the transition period are however still to be defined. The UK government has expressed its preference for a Canada-style agreement [2] (i.e. a tariff-free, quota-free trade deal for goods, going possibly somewhat further than the current CETA agreement in some areas such as the range of products covered, but involving new frictions at the borders) and has also threatened to discontinue talks and leave the EU on WTO (World Trade Organisation) terms (i.e. Australia-style exit)[3] if no agreement has been reached in June. Moreover Britain has also reiterated its refusal to be bound by a strict alignment of rules with the EU or to be subject to the European Court of Justice as the ultimate interpreter of EU law.

The EU has however indicated that such a tariff and quota-free trade deal would require that the UK should sign up to level-playing field commitments - i.e. the upholding of common high standards using EU standards as a "reference point" (in areas such as State-aid, competition, social, employment and environmental standards, certain relevant tax and regulatory matters[4], etc...). In addition the EU has proposed an overarching agreement with one single dispute-settlement system, rather than separate deals covering different areas.

The UK government has claimed that it is not ready to accept such conditions that may go against its objective to keep control on the future direction of UK regulations, arguing also that other nations that have concluded trade agreements with the EU have full regulatory autonomy and that the criteria put forward by the EU to justify different requirements for the UK are irrelevant (closer geographical proximity and higher intensity of trade [5]). The UK has nevertheless stated that it will maintain high standards and agreed to commit not to undercut existing EU regulations in areas such as environmental policy and labour laws, but does not want these commitments to be covered by the trade agreement's dispute-settlement system. In any case a possible EU-UK trade agreement would most probably be mainly focused on goods and would have limited impact on financial services.

Equivalence as the way forward in the financial sector

Regarding the financial services sector, equivalence arrangements were agreed to be the basis for future EU-UK relations in the political declaration related to the withdrawal agreement (dated October 2019). This would concern the 40 areas or so of financial services covered by such arrangements[6]. It was also agreed that the EU[7] and UK "should start assessing equivalence with respect to each other as soon as possible after the UK's withdrawal from the EU, endeavouring to conclude these assessments before the end of June 2020". This reliance on equivalence arrangements has since been reaffirmed in the respective negotiation mandates of the EU and UK, with an emphasis also on regulatory and supervisory cooperation.

The UK (in the perspective of Brexit) and some other third-countries such as Switzerland have been criticizing EU equivalence arrangements for their lack of predictability (agreements can be unilaterally discontinued with a 30 days' notice period), the alleged

[1] Some have suggested that the temporary suspension of Brexit negotiations due to the coronavirus crisis may lead to an extension of this standstill period, one reason being the time needed for companies to adapt to the new market situation, once a deal (or no deal) has finally been agreed. That would however mean changing the UK law which commits to put an end the transition period in December 2020.

[2] The CETA (Comprehensive Economic and Trade Agreement) between the EU and Canada is not a zero-tariff, zero-quota deal, but it does eliminate most tariffs (taxes on imports) on goods traded between the EU and Canada. Tariffs remain notably on poultry, meat and eggs. It also increases quotas (the amount of a product that can be exported without extra charges) but does not eliminate them altogether (e.g. quotas remain on EU cheese exports to Canada). CETA however does little for the trade in services - except imposing rules such as the most-favoured nation clause (i.e. the non-discriminatory treatment of third-countries) or the elimination of quotas for foreign providers - and nothing specifically for the trade in financial services.

[3] Under WTO rules, each member must grant the same 'most favoured nation' (MFN) market access to all other WTO members (and related customs checks, tariffs, quotas and regulatory conditions), except to countries who have chosen to enter into free trade agreements and preferential market access possibly granted to developing countries. To provide services in other countries UK providers will need to follow the terms set out in the legislation of the host country and vice versa.

[4] such as abiding by OECD protocols.

[5] The Commission explains that every trade deal has a level playing field element to it and that each agreement with a third-country depends on a number of different factors including distance and the level and intensity of trade. The greater geographical proximity of the UK and the intensity of its current trade with the EU justify specific level playing measures compared to e.g. Canada, according to the Commission.

[6] Equivalence regimes exist for financial services related to securities and derivatives transactions (MiFID, EMIR, CSDR, SFTR) and for services and products targeting professional customers and eligible counterparties (investment services under MiFIR, AIFMD) and reinsurance activities. There is also an EU equivalence regime for credit rating agencies and financial benchmarks. However, most core banking and financial activities are not subject to an equivalence regime providing access to the single market. This includes deposit-taking and lending in accordance with the Capital Requirements Directive; payment services in accordance with the Payment Services Directive; and investment services for retail clients. In addition there is no third-country regime for investment funds targeting retail clients (UCITS and AIFs) and most insurance activities except reinsurance.

[7] At this stage the negotiation mandate of the EU mentions the respective unilateral equivalence frameworks of the EU and UK as the key instruments the parties will use to regulate interactions between their financial systems, with a commitment to cooperate in order to preserve financial stability, market integrity, consumer protection and fair competition.

politicization of equivalence determinations (with assessments that may take into account criteria that go beyond purely technical regulatory aspects) and the cumbersomeness, level of detail and lack of transparency of the EU equivalence process.

For its part, the Commission reaffirmed in two recent communications (Working Document - February 2017 and Communication - July 2019) the main principles guiding EU equivalence arrangements in the area of financial services and has repeatedly claimed that its equivalence policy is fit for purpose for handing future EU-UK relations in the financial sector. The Commission's view is that equivalence needs to be conducted in a proportionate way, depending on the risks implied by the third-country considered in terms of financial stability, market integrity and customer protection. This means that the higher the potential impacts of a third-country market are on the EU, the more thorough an equivalence assessment should be. The Commission has moreover stressed that in terms of process, these assessments look at the outcomes of third-country regulation and supervision rather than an identity of rules. In addition, decisions to withdraw equivalence are not abrupt and take effect, depending on the circumstances, after a possible transition period and can be restored or limited in time [8].

In its July 2019 communication, the Commission moreover mentioned some improvements underway regarding equivalence processes. Efforts have been made notably for increasing their transparency and accountability, with e.g. measures to improve the information provided regarding the way EU equivalence processes work and how equivalence assessments are progressing [9].

In January 2020 changes were also made to the supervisory toolbox related to EU equivalence arrangements that should facilitate their monitoring by the European Supervisory Authorities (ESAs). Each ESA is to perform the monitoring of equivalent third country regulations and to submit a report on these monitoring activities to the European institutions on an annual basis. The ESAs have also been provided with more resources following the ESFS review that should allow performing more regular and detailed assessments of the third-countries concerned. In the capital markets area EMIR 2.2 and the reviewed Investment firm regulation have introduced changes regarding non-EU players, notably with a stricter recognition regime for systemically important third-country CCPs that will have to comply with EMIR requirements and be subject to certain supervisory powers of ESMA. Extending the supervisory role of ESMA in relation to non-EU trading venues and CSDs is also envisaged.

On-going EU-UK discussions regarding equivalence

At the beginning of 2020, UK representatives reiterated their concerns with the existing EU equivalence approach, notably its lack of predictability, and also their refusal to become a rule-taker in a sector of such vital importance for the UK as financial services. Proposals have been made by the UK, notably in their approach to EU-UK trade negotiations (February 2020), to move towards a more balanced, structured and principles-based system concerning the withdrawal of equivalence arrangements. The EU has so far rejected these proposals on the grounds that this approach would undermine the EU's regulatory decision-making autonomy and also that the same system should be used for all third-countries.

The timing of equivalence negotiations is another issue. Given the current identity of UK and EU rules, the UK has urged the EU to conclude equivalence assessments by June 2020, in line with the objective mentioned in the political declaration of the withdrawal agreement, in order to avoid any market disruptions. But the Commission has warned that this deadline only refers to the mapping of equivalence assessments and not to the decisions themselves, which would be guided by how far Britain wants to deviate from EU rules, particularly with regard to rules that may impact financial stability or consumer protection, considering the systemic importance of the UK-based financial sector for the EU.

Moving more quickly on equivalence has not been included in the negotiating mandate of the EU, which sees this as a strictly unilateral matter. Moreover, the Commission considers that the risk of a cliff edge at the end of 2020 is exaggerated, given the additional time that the industry has to adapt its operations during the transition period. Some observers however suggest that this is also a way for the EU to keep access rights for financial services as a bargaining chip in the broader discussions on trade with the UK.

Implications of equivalence negotiations for the EU and UK

The way equivalence is implemented between the EU and UK may change to a certain extent the current dynamics in the EU and UK financial markets, which are essential for both economies, potentially raising costs for clients or splitting up existing processes and flows with new barriers.

Achieving appropriate equivalence arrangements with the UK is important for the EU, given its current dependence on UK-based financial activities, particularly in the wholesale capital market area. For example, almost half of all debt and equity issuance for non-financial institutions in the Eurozone is carried out by global banks based in London, up to 90% of certain euro-denominated swap transactions are cleared in London… This dependence is likely to continue if the transfer of activities to the EU remains limited and also until the EU develops sufficiently deep, liquid and integrated capital markets, possibly thanks to the Capital Markets Union (CMU) initiative. The UK will also be putting in place its own equivalence arrangements which may impact to a certain extent EU players operating in the UK. At the same time providing longer-term (or possibly permanent) stability to an equivalence regime would offer the UK a status fairly close to being in the single market for the activities concerned, which is not acceptable for the EU.

For the UK, beyond possible internal political considerations, the question is whether the opportunities offered by divergence from EU financial directives such as MiFID II or Solvency II and avoiding the possible downsides of being a "rule-taker" or "outsourcing financial regulation to the EU" (in terms of risk mitigation or adequacy of rules to UK needs) are worth the cost of losing access to EU markets, which at present make up about 20% of activity in the City. In addition the opportunities and downsides of divergence may vary across financial activities when taking into account specific market dynamics and the (incomplete) coverage of EU equivalence arrangements. Whether the business continuity risk of current equivalence arrangements is acceptable for UK-based market players and the feasibility of possible alternatives (e.g. increasing presence in the EU) are also an important factor.

[8] EU representatives have also explained on other occasions that although steps and timelines are not strictly defined, a withdrawal of equivalence only happens after an in-depth assessment normally performed by one of the ESAs. Moreover, equivalence assessments have to take into account several micro and macro dimensions (beyond regulatory requirements related to the policy under consideration) including investor protection, potential systemic risks, as well as AML, market disruption or level playing field aspects, in order to ensure that EU markets and customers are not exposed to unwanted risks as a result of equivalence agreements (see Summary of Discussions – Eurofi Bucharest Seminar April 2019).

[9] For example the Commission now generally submits for public consultation draft equivalence decisions that are envisaged for adoption with a 30 day feedback period.