

Position paper

of the Association of German Banks on the
further development of the EU's equivalence regime

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Executive summary

The European Union's equivalence regime has been a focus of discussion in the recent past. Some main points of criticism are the lack of a standardized, transparent EU framework, the limited areas covered by equivalence, and the lack of a uniform benchmark. This leads to a patchwork of short- and long-term equivalence decisions and a complex, unstable, and unpredictable system as a whole.

Therefore – while welcoming the recent developments in the existing regime – the Association of German Banks (BdB) calls for further enhancements for the benefit of the EU internal market and market participants.

In particular, we recommend the following (mainly non-legislative) actions to increase the predictability of the framework and better enable market participants to rely on it:

1. Establishing a more objective decision-making mechanism and consistent principles for the assessment of third-country equivalence.
2. Expanding the scope of current equivalence rules.
3. Enhancing reliability, predictability and transparency.
4. Encouraging a standardised two-way market access.

The present position paper

- discusses the potential benefits of a well-functioning equivalence regime as well as the recent changes and the remaining shortcomings of the current EU equivalence regime;
- provides detailed recommendations on potential improvements to the system and processes; and
- substantiates the arguments with a number of recent examples.

Third-country equivalence in the area of banking and financial services

The EU's equivalence regime

'Equivalence' refers to the process whereby the European Commission assesses and determines that a third country's regulatory, supervisory and enforcement regime is equivalent to the corresponding EU framework. That recognition makes it possible for the competent authorities in the EU to rely on third country entities' compliance with the third-country framework, which has been deemed 'equivalent' by the Commission.

'Equivalence' does not mean that the third country's framework is 'identical' to the EU framework. Nor is it substitute of the 'European passport', i.e. the right to establish branches in other EU Member States or provide financial services across the EU without the need for further authorization. The equivalence assessment rather looks at the regulatory and supervisory frameworks in order to reduce overlaps, while also taking into account the related risks. To adequately manage the risks, equivalence decisions can include conditions or limitations of the equivalence granted.

Benefits of a well-functioning equivalence regime

The benefits of a reliable, stable, predictable and transparent equivalence framework are manifold:

- It supports EU and non-EU market participants' ability to take better informed strategic decisions with regard to cross-border financial activities.
- It can contribute to an increased international activity and, thus, enhanced competition in the EU financial markets.
- Due to the global nature of financial markets, a clear and robust regulatory framework applying to these transactions can encourage cross-border transactions and contribute to further opening access to capital markets.
- It can contribute to the EU's emergence as a global standard-setter in cross-border financial agreements and, in turn, increase the global role of the EU.
- By providing a robust regulatory framework through which access to third-country markets is facilitated, the equivalence regime promotes financial stability and market integrity.
- It can allow EU firms to deal with the extraterritorial scope of the EU regulatory framework, especially, when non-EU branches have to deal with non-EU counterparties.

Recent changes and developments

In July 2019, the European Commission published a communication discussing recent developments in the current equivalence regime and outlining future directions. In the communication, an overall reform of the regime was not foreseen. At the same time, the European Commission confirmed that improvements that did not require legislative action have been made. The improvements addressed enhancing the proportionality of the decision-making process, adapting a more risk-sensitive approach and increasing the transparency of the system and related processes. However, equivalence decisions will remain unilateral and discretionary acts of the Commission.

In parallel, a number of legislative improvements have been finalised and taken effect, contributing to further improvements in the equivalence regime. Two key developments are the revised European Market Infrastructure Regulation (EMIR 2.2) and the new prudential framework for investment firms.

The recent amendments of EMIR 2.2 – which have come into force on 1 January 2020 – include an improved, risk-based supervisory toolbox at entity level, a stronger role for ESMA and the central banks of issue as well as the establishment of a Central Counterparty (CCP) Supervisory Committee. The exact process for these equivalence decisions and the enhanced supervision for systemically important third-country CCPs will be developed over time. Nevertheless, it should be ensured that any decisions taking a risk-based approach are made on the basis of regimes, which create the same outcomes rather than regimes, which are identical.

With the adoption of the Investment Firms Directive (IFD) and Investment Firms Regulation (IFR) in November 2019, a new prudential framework for investment firms has been introduced, which simplifies the existing CRR/CRD regime. One major change relates to the equivalence of investment firms in Markets in Financial Instruments Regulation (MiFIR), which would allow third-country firms to provide services to professional clients and eligible counterparties on a cross-border basis. The newly introduced process for equivalence decisions in this area creates a more coherent obligation for a detailed and granular assessment of the third-country regulatory frameworks, including the assessment of whether the scope of services provided by third-country firms can be considered to be of systemic importance to the EU. It also introduces an ongoing requirement for third-country firms making use of this equivalence decision.

These new types of equivalence decisions appear to provide more clarity regarding the process and include a more proportional approach to third countries or third-country entities which are not regarded as systemically important. It is further to note that these equivalence decisions do not prevent effective equivalence by putting in place thresholds which are unachievable for third countries.

As such, the BdB welcomes the recent developments in the existing regime and acknowledges their benefits but advocates for further enhancements for the benefit of the EU internal market and market participants.

Shortcomings of the current EU equivalence framework

Based on our assessment, the following shortcomings are the most important barriers towards realising a reliable, predictable and transparent framework:

- The lack of a uniform, harmonised, and transparent decision-making process and a uniform benchmark. Under the existing equivalence rules, both the responsibility and procedure for recognition of equivalence differ depending on the underlying EU legal act.
- The lack of stability and long-term perspective, i.e. the possibility of short-term changes and even short-term withdrawals of equivalence decisions.
- The lack of coordination and alignment among decision-making institutions as well as standardised, consistent, over-arching principles in the decision-making process.
- The limited scope of equivalence decisions.
- The lack of a standardised two-way market access.
- The lack of a formalised framework to withdraw equivalence decisions.

Establishment of a well-functioning equivalence regime

In line with the gaps identified in the previous section, the BdB recommends the following actions to establish a well-functioning equivalence regime and enable EU market participants to more predictably rely on equivalence decisions.

Recommendation 1 – Consistency and objectivity

We recommend the establishment of a legal framework of general principles on equivalence rules, which should form the basis for any equivalence decision.

The framework should, at least, stipulate the following:

- The process for initiating equivalence decisions;
- The assessment process and assessment period;
- The general principles applying to the preparation of the assessment;
- The tasks of the competent agencies during the preparation of the assessment;
- The involvement of other European and national bodies and authorities;
- The rights of control for the European Parliament and the Council;
- The required monitoring and related procedures;
- A formalised framework to withdraw equivalence decisions; and
- The framework for cooperation with third-country authorities during the initiation, assessment, monitoring, review and withdrawal processes.

In addition, irrespective of any uniform framework, the framework should retain a degree of flexibility to address specific needs (such as cross-border market access and financial stability) or to provide for special procedures for cooperation with third-country authorities.

Recommendation 2 – Expanding the scope

Various provisions in the field of securities law (e.g. MiFID II/MiFIR, EMIR, Central Securities Depositories Regulation – CSDR) and banking supervision already provide for equivalence rules today. However, as these rules are not harmonised and apply only to small, clearly defined areas, there are still fields – particularly financial services – in which there are no rules.

As such, we recommend that the scope of services that may be provided via equivalence be expanded to further regulatory areas. Payment services and custody services are some of the key fields, which should be included in the regime. In addition, the framework could be extended to non-business related regulation, such as Anti-Money Laundering and Counter-Terrorism Financing (AML/CFT) legislation.

Recommendation 3 – Enhancing reliability, stability, predictability and transparency

Transparency and predictability should be increased through the whole process, including the initiation and withdrawal of equivalence decisions. This can be achieved through the establishment of a formalised framework to address disagreements.

For example, initiation of equivalence decisions could be made mandatory with Financial Stability Board (FSB) members if the regulatory outcomes in question are the result of an FSB agreement. FSB progress reports could give solid guidelines of countries and areas of law, which could be considered favourably. Also, existing laws allowing for equivalence decisions could be used more actively. Examples are the Prospectus Regulation (Art 29 [EU] 2017/1129), as a result of which bonds are often offered by way of private placements, and the Benchmark Regulation (Art 30 [EU] 2016/1011).

As a further illustration, the withdrawal of an equivalence recognition can become effective within a very short deadline, often without any clear-cut procedure for suspension of an equivalence decision. Financial institutions and their customers need stability, predictability and legal certainty. To minimise the risk of unilateral withdrawal or suspension at short notice, there needs to be a formalised consultation framework through which to address any regulatory outcome disagreements that may emerge between the EU and the third country, which provide for private sector input. Only then should withdrawing recognition of equivalence be possible. Until then, despite differing legal frameworks, the third-country provisions should be regarded as equivalent.

Recommendation 4 – Encouraging a standardised two-way market access

Where an EU equivalence decision is adopted, the European Commission should urge third countries to grant European entities corresponding market access. One way to address this would be setting two-way cross-border market access as a condition for granting and later for extending the equivalence.

Recent cases and future directions

U.S. 'Substituted Compliance' in commodity futures trading

In March 2016, the U.S. Commodity Futures Trading Commission (CFTC) issued a substituted compliance framework for dually-registered CCPs located in the EU that are also CFTC-registered derivatives clearing organizations (DCOs). Under the substituted compliance regime, if the CFTC deems certain non-US swaps rules comparable to its own, it may permit parties subject to its jurisdiction to comply with their "home" rules in place of its own. The CFTC also issued a related comparability determination to further harmonise the CFTC and EMIR regimes without risking regulatory arbitrage. The determination outlines the circumstances, under which foreign-based CCPs are required to register with the CFTC. Registered CCPs must comply with the relevant US requirements, including CFTC regulations applicable to registered DCOs. However, under the determination, DCOs/CCPs may comply with certain CFTC requirements (e.g. for financial resources, risk management, settlement procedures) by complying with corresponding requirements under EMIR.

Switzerland's lost equivalence status for stock markets

Until July 2019, a temporary equivalence decision between Switzerland and the EU ensured that the trading of equity securities listed on Swiss exchanges was possible on stock exchanges in the EU. However, due to political considerations that had no connection to the trading of shares, the European Commission allowed the equivalence arrangement for Swiss stock markets to expire at the end of June 2019. This highlights the lack of predictability, transparency and certainty inherent within the equivalence regime.

As the shares of the largest Swiss stock companies are traded both in Switzerland and on EU exchanges, the ceasing of Switzerland's equivalence status would have banned EU investment firms from trading these shares on the Swiss stock exchanges. To prevent this, the Swiss government prohibited shares of Swiss companies which are listed or traded on a Swiss stock exchange from being traded on EU exchanges (Federal Council Ordinance).

As a consequence, the restriction under MiFIR no longer applies to Swiss equities, which means that EU investment firms are released from the requirement to trade them on EU trading venues. The final result is that shares of companies listed on the Swiss stock exchange are no longer traded on EU exchanges and EU investors are instead buying and selling these shares through third-country providers.

According to the think tank Bruegel, the loss of equivalence has left Swiss entities neither worse nor better off. However, this legal manoeuvre has led to additional capital inflows and increased trading volume at the leading Swiss stock exchange SIX, as Swiss companies previously only listed in the EU returned to the Switzerland. At the same time, as a response to Switzerland's expired

equivalence status, the Swiss government has issued the Swiss Financial Services Act, which has come into effect in January 2020. Under the new regulation, financial services providers active on Swiss markets are required to register in an Advisory Register. This results in additional bureaucratic requirements and ongoing compliance costs, and thus, expectedly, will discourage EU financial services providers from entering or remaining active on Swiss stock markets. This has also negatively affected EU investors with lower liquidity in the pertinent shares trading in the lit market, and increased execution costs.

Time-frame and procedural challenges of equivalence negotiations

The United Kingdom's withdrawal from the EU triggered a broad discussion regarding the EU's equivalence regime. It shed light on the lack of consistency and harmonization among the various parts of framework and brought attention to the long time-frame and the procedural challenges of equivalence negotiations.

The Brexit-triggered equivalence discussions have also highlighted the need for simple and transparent processes to avoid possible regulatory conflicts and the uncertainty on financial markets, thus encouraging investment decisions and supporting market participants in their long-term business decisions.

The ongoing equivalence decision process for the Hong Kong Interbank Offered Rate (Hibor) and the Hong Kong Dollar Overnight Index Average (Honia) is another example of the prolonged decision-making process and the resulting uncertainty on international financial markets. Hong Kong has been seeking equivalence for its local rates, the Hibor and the Honia, from European benchmark regulators since mid-2019 and the process is expected to be completed only by the end of 2021. The long time-frame and the possibility of further delays leads to a high degree of market uncertainty and instability, partly resulting from the postponement of cross-border investment decisions and the decreased market efficiency due to the limited liquidity of international financial markets.

Dealing with non-equivalent third countries

As part of the further development of the EU equivalence regime, a sound legal basis should be created, setting out how European financial market participants can deal with counterparties from third countries that are not regarded as equivalent. This question is raised, for example, on the interbank market or when a bank does business with a broker in an emerging market. Business relationships between commercial banks and other professional market participants form the core of the global financial system, and the associated flows of liquidity should be retained as far as possible. Furthermore, a carve-out for the inter-dealer market ought to be provided for the purposes of stability and liquidity.