Brexit Quick Brief #12

UK FINANCE

Equivalence in a future EU-UK trade framework for financial services

Executive Summary

This paper examines the EU's current approach to equivalence and offers practical recommendations for how an enhanced form of equivalence, respectful of the sovereignty and other objectives of each of the parties, may be achieved.

With thousands of EU and UK financial services firms operating between the two jurisdictions, understanding the ways in which the rules governing financial services of the two markets are comparable will influence how they are regulated and supervised after the UK departs from the EU and becomes a 'third country' – the term used by the EU to signify a country that is not a member of the EU or the EEA.

Such determinations of comparability can also be the basis for rights and obligations to provide financial services cross-border, preserving some of the most important elements of market integration available to EU and UK based businesses today, although in a more limited manner than the 'passporting' rights enjoyed by members of the EU's single market.

The EU has a range of established frameworks for providing such determinations under its 'equivalence' regimes. These perform a range of functions and condition the way contracts and interactions of EU (including EEA) and non-EU banks and investment firms are supervised.

Separately, the UK government has published its initial proposals for a future trading relationship with the EU in financial services which contemplates that an enhanced form of the EU's equivalence regimes will be an important part of a future trade relationship for financial services between the EU and the UK.

This paper examines the EU's current approach to equivalence and offers practical recommendations for how an enhanced form of equivalence, respectful of the sovereignty and other objectives of each of the parties, may be achieved.

What the EU's regimes generally do not do in their current form is provide a legal basis for cross-border contracting between EU customers and non-EU suppliers across a wide enough range of financial products. And even where the provision of such cross-border services is in theory available under the current EU regimes for certain important financial products, these have yet to be activated. For this reason, while they provide a potential starting point for a future EU-UK trade relationship in financial services, preserving some of the financial products that businesses on both sides rely on, their application would need to be transformed in some key respects to be more appropriate:

- The scope of current equivalence regimes with respect to cross border contracting rights would need to be expanded to include core products and services currently not covered, and existing equivalence regimes that would permit the cross-border provision of certain other core products and services should be activated.
- The protocols for making equivalence determinations should be refined to make them as transparent and collaborative as possible, preferably based on objective prudential criteria, guided by market needs and technical regulatory considerations, seeking to avoid politicisation.
- The protocols for withdrawing equivalence determinations should be refined, not to limit the regulatory autonomy of either side, but to ensure that that autonomy is exercised transparently, predictably and with due consideration for the need of businesses and customers for sufficient time to adapt to change.

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It will also be important that provision be made in a Withdrawal Agreement to ensure that equivalence judgements by both the EU and the UK can be made and applied before the UK exits the EU single market, even where the EU and the UK are not in other respects treating each other as 'third countries' in legal terms. If this is not possible, temporary arrangements for the period following the UK exit will be required to allow these judgments to be made and applied after exit.

In principle, these enhancements and contingency planning steps could be applied through a mix of binding commitments in an EU-UK Free Trade Agreement or Association Agreement, unilateral legislative change and regulatory and supervisory cooperation. This can be done while protecting the fundamental autonomy and sovereignty of both the EU and the UK, and should be the aim of both sides.

What is equivalence?

Equivalence has an important role in international trade and is of particular significance for financial services trade with the EU.

Equivalence has an important role in international trade (see box 1) and is of particular significance for financial services trade with the EU. In banking, the EU uses equivalence judgements for two main purposes. First, as the basis for granting a non-EU bank certain rights in the EU market. Second, in defining the rights and regulatory treatment of EU banks when they operate in a market outside the EU. In some limited cases, equivalence is used as the basis for market access rights in the single market. In many cases, however, it is not linked to market access rights in this explicit way. Instead it provides reliefs from the general treatment of foreign (i.e. non-EU) firms or regimes.

EU equivalence judgements can cover a wide range of areas and have a range of different effects. For example:

- Treatment of Third Country Branches located in the EU: Assessments of the prudential standards of a non-EU and non-EEA country (known as a "third country" in EU terminology) are used to determine the ways in which bank branches from those countries are treated in the EU and to determine any additional requirements the EU may impose on them. These are generally determined at the EU member state level.
- Treatment of EU banks interacting with third country entities: Assessments of prudential and other standards are used to determine what sorts of risk management requirements are imposed on EU banks by EU supervisors when those banks lend or take other exposures to parties in another country. Banks can generally hold less capital against exposures to other banks in 'equivalent' jurisdictions. The EU has reached such determinations for a number of countries including Australia, the US, Switzerland, India, Brazil and Canada.
- Treatment of EU banks using third country financial infrastructure: Assessments of market infrastructure standards in a third country are used to determine whether EU banks can be clearing members of clearing houses there and can meet their obligations to clear securities trades through those clearing houses as they would in the EU. It also determines how exposure to such market infrastructure will be treated for risk management purposes. The EU has reached such determinations for jurisdictions that include Canada, the US, Korea and Japan (see Box 2).
- Cross-border provision of certain financial services by firms in third countries to professional customers in the EU: Assessments of a range of standards in a third country for the authorisation and supervision of firms providing investment services in relation to securities, funds and derivatives, including rules of conduct and market transparency rules, can in principle be used to create the basis on which certain investment services can be provided to EU professional customers from outside the EU. This potentially covers a range of important services such as the buying or selling of securities, funds and derivatives, portfolio management, investment advice and the underwriting and placing of new issues of securities. However, this form of EU-level equivalence is yet to be activated. It may in fact be revised to become narrower.
- Movement of personal data between the EU and a third country: Assessments of the adequacy of data protection standards of a third country are used to determine the freedom with which banks and other firms can move personal data on employees

Aligning a country's rules closely with those of the EU does not in itself guarantee treatment as equivalent by the EU.

or customers across borders between the EU and the third country. The EU has reached such determinations for a range of jurisdictions including Canada, Israel, and Switzerland. In the case of the US, the EU has achieved a similar outcome via the bespoke Privacy Shield framework.

The precise EU approach to determining equivalence varies from area to area. It is not based on a direct or exact transposition of EU laws into another country's rulebook but on a close comparison of the intent and outcomes of the EU system and that of the other country. In some cases, the granting of equivalence is also based on the requirement that the other jurisdiction extend reciprocal recognition to the EU and to EU firms. Aligning a country's rules closely with those of the EU does not in itself guarantee treatment as equivalent by the EU. This remains the prerogative of the EU authorities.

Box 1: The use of Equivalence in international trade policy and in EU regulation

WTO Equivalence

The term equivalence has wide usage outside of the EU in international trade policy, where it can often mean something different from the way it is used in EU rules. In international trade policy equivalence is generally classified as a form of 'recognition'. It generally denotes a framework in which two parties 'recognise' that their regulatory frameworks are sufficiently comparable or aligned to allow a certification, license or registration granted in one to be accepted as valid, in its own right, in the other. Equivalence judgements in World Trade Organisation frameworks can be unilateral or made as part of a bilateral agreement.

EU Equivalence

The use of the term 'equivalence' in EU financial services regulation generally does not imply this type of recognition, or that an authorisation or license in the third country is sufficient to allow the provision of regulated services in the EU. As set out above, EU equivalence is generally applied at the level of a general regulatory framework to allow supervisors to make a range of judgements about risk and risk management. The EU itself also uses a range of names for these judgements. For example, in the area of data protection they are described as 'adequacy' determinations.

Despite their different uses, at the heart of all these approaches is the same basic concept of assessing the comparability of two financial services regulatory regimes to determine how their firms can interact and how they are treated when they do. How such 'recognitions' will work between the EU and the UK will be an important building block of their future financial services relationship.

Using equivalence, in its current or any future form, respects the EU's prerogatives.

In some cases, equivalence judgements are made at the EU level, by EU authorities. For example, this is the case for assessments of data protection and market infrastructure standards, as these are established frameworks at the EU level. In others, the equivalence judgement is left to national supervisory authorities in the EU – for example, judgements on the home regulation of branches of foreign banks in the EU is a national prerogative, as such branches are solely supervised at the national level and currently have no cross-border rights inside the EU[1].

Using equivalence, in its current or any future form, respects the EU's prerogatives of maintaining the Single Market as a unique construct meant for Member States only. It allows the EU to calibrate the access granted to the degree required to support the EU and EU firms' beneficial access to global markets. It retains the ultimate autonomy of decision making with the relevant EU bodies, and provides the EU with an ongoing ability to monitor third country access to the Single Market.

These sorts of recognitions between the EU,

[1] Note that in some specific cases where a firm has a branch in a member state and its home jurisdiction has been recognised as equivalent under MiFIR it would be able to provide services under its approval to eligible counterparties and professional clients across the single market. However, no such equivalence determinations have been granted by the European Commission as of August 2018.

EU member states and the UK will be extremely important once the UK has left the EU single market for financial services. They will condition the regulatory treatment of exposures between the two markets. They will define the way both EU and UK banks and investment firms are treated when they establish branches or full subsidiaries in each other's market, replacing the current, highly preferential terms created by the single market. Both the EU and the UK agree that this kind of close relationship contributes to a more dynamic, competitive, cost-efficient and growth-supporting banking and financial services sector, and that it brings benefits to customers in both markets.

To preserve such benefits will require timely and widespread use of equivalence determinations by both the EU and the UK, covering more products then possible today.

Box 2: EU equivalence in practice

Under the EU's existing equivalence procedures, securing recognition can be complex and unpredi-ctable, and is rarely fast.

EMIR Equivalence for the Chicago Mercantile Exchange (2012 -2016)

Under the EU's existing equivalence procedures, securing recognition can be complex and unpredictable, and is rarely fast.

A good example of this is the 'recognition' regime for third country central counterparties (CCPs) in the 2012 European Market Infrastructure Regulation (EMIR). These CCPs play an important role in securities markets, acting as an intermediary between the buyers and sellers of derivative contracts, guaranteeing both sides against the failure of the other. Since the crisis of 2008 regulators have encouraged and required wider use of CCPs. For this reason, the EU has developed a system of recognising CCPs in countries outside the EU that EU firms can use to meet their clearing obligations under EU law. EU firms using unrecognised CCPs to clear products that are subject to the clearing obligation incur punitive capital treatment for exposure to non-qualifying CCPs (ie. CCPs which have not been authorised or recognised under EMIR).

Assessing equivalence proved particularly complex when the analysis was applied to the United States, where many EU banks rely on the CCP provided by the Chicago Mercantile Exchange (CME) to clear 'eurodollar' derivatives that protect them against movements in US interest rates. EU and US regulators were initially unable to resolve the question of whether the two systems guaranteed similar outcomes, even though they differed in some technical details. Negotiations advanced slowly, then stalled.

After four years, and only with the deadline for mandatory clearing hanging over EU banks, EU regulators finally granted the US system equivalence, and the CME was recognized by ESMA shortly afterwards. As a condition of an EU equivalence judgement, the US was required to extend mutual recognition to EU CCPs. This was done in March 2016.

MiFIR Equivalence for Third Country securities and derivative trading activity (2014-20?)

The majority of the c. 283 equivalence determinations made by the EU Commission to date have dealt with elements facilitating EU firm activities in third countries (such as central bank exclusions or capital treatment of non-EU exposures by EU firms). They have not addressed the cross-border access by third country firms to the EU.

The majority of equivalence determinations made by the EU Commission to date have facilitated EU firm activities in third countries.

Breakdown by Category of EU Equivalence Decisions for countries (September 2018)

c. 283 jurisdictional equivalence decisions to date reported by the European Commission. Of these:

- 152 relate to EU firm capital treatment of non-EU exposures under prudential requirements: 144 under Capital Requirements Regulation (CRR), 8 under Solvency II Directive
- 54 relate to auditing and accounting standards: 42 under Statutory Audit Directive, 6 under Transparency Directive, 5 under Prospectus Directive and 1 under Accounting Directive
- 33 relate to exemptions for central banks: 13 from insider trading (Market Abuse Regulation), 12 under Markets in Financial Instruments Regulation (MiFIR), 8 under European Market Infrastructure Regulation (EMIR);
- 25 allow EU entities to use third country CCPs, Regulated Markets or trading venues: 15 for Central Clearing Counterparties (CCPs) under EMIR, 5 for regulated markets under EMIR, 4 for trading venues under Art 25 of Markets in Financial Instruments Directive II (MiFID II, relating to MiFIR), 1 for CCPs under MiFIR (USA Commodity Futures Trading Commission (CFTC) – European Securities and Markets Authority (ESMA) Memorandum of Understanding (MoU))
- 9 relate to legal & supervisory framework of credit rating agencies under the Credit Rating Agencies Regulation (CRA)
- 2 relate to equivalence of group supervision (having EU subsidiaries) by third country supervisory authorities under Solvency II
- 1 relates to Transaction reporting requirements under EMIR
- Only 3 allow equivalent treatment of third country reinsurers in the EU for cross border market access under Solvency II Directive/Omnibus Regulation. Aside from these 3 determinations there are no other activated equivalences for third country market access into EU Single Market.

Source: European Commission; UK Finance analysis

One of the limited areas where EU equivalence is in principle available today for provision of certain cross-border financial services for EU professional customers by third country firms is the EU Markets in Financial Instruments Regulation (MiFIR). Implemented in 2014, MiFIR covers a cornerstone set of financial risk management products used frequently by many businesses to manage their currency, interest and inflation risk.

The table below is extracted from the European Commission's overview table of Equivalence/ Adequacy Decisions (as of 9 January 2018, which remains the same as at the time of writing in September 2018) on the Commission's website and lists the different types of activity for which equivalence is in principle available for MIFIR. To date the EU has only granted equivalence in two MiFIR categories: a narrow exemption for transactions with certain third country central banks; and a narrow type of exemption in relation to permitted trading venues for the derivatives trading obligation which has to date only been activated for the United States[2].

The majority of potential MiFIR equivalence categories are still pending activation, including the important category for cross-border provision of securities, derivatives and other services to professional customers in the EU.

[2] To date the EU has only granted an equivalence decision under MiFID 2 Art. 25 (which provides for equivalence in relation to permitted trading venues for the share trading obligation under MiFIR) to four countries.

Both these examples illustrate the practical challenges around the current procedures for timely activation of the EU's existing equivalence mechanisms offering the possibility for limited cross-border financial services provision for customers.

Not only will the UK potentially have to navigate this process and others like it with the EU in securing equivalence for itself, but it will need to develop its own domestic regime for recognising the equivalence already granted by the EU to exchanges like the CME. The UK will also need formal systems for assessing and recognising the equivalence of EU rules with its own. The EU and the UK should put in place timely and transparent processes for achieving all these outcomes.

In short, the EU and UK should both have an interest in establishing fast-track mechanisms to allow such mutual assessments to be accomplished prior to the UK's exit from the EU and in a timely manner going forward.

Regulation (EU) N° 600/2014 on markets in financial instruments (MIFIR)	Abu Dhabi	Argentina	Australia	Bermuda	Brazil	Canada	Caymans	China	Dubai	Egypt	Faroe Islands	Greenland
Art.1(9) - Exemption central banks			Y			Y	Y					
Art.28(4) - Trading venues for the purposes of trading obligation for derivatives												
Art.33(2) - Derivatives: trade execution and clearing obligations												
Art.38(3) - Trading venues and CCPs-access to benchmarks and licences for the purposes of clearing and trading obligations												
Art.47(1) - Investment firms providing investment services to EU professional clients and eligible counterparties												

Regulation (EU) N° 600/2014 on markets in financial instruments (MIFIR)	Guernsey	Hong Kong	India	Indonesia	Isle of Man	Japan	Jersey	Malaysia	Mauritius	Mexico	Monaco	New Zealand
Art.1(9) - Exemption central banks		Y	Y			Y				Y		
Art.28(4) - Trading venues for the purposes of trading obligation for derivatives												
Art.33(2) - Derivatives: trade execution and clearing obligations												
Art.38(3) - Trading venues and CCPs-access to benchmarks and licences for the purposes of clearing and trading obligations												
Art.47(1) - Investment firms providing investment services to EU professional clients and eligible counterparties												

Regulation (EU) N° 600/2014 on markets in financial instruments (MIFIR)	Russia	Saudi Arabia	Singapore	South Africa	South Korea	Switzerland	Taiwan	Thailand	Turkey	USA	UAE
Art.1(9) - Exemption central banks			Y		Y	Y			Y	Y	
Art.28(4) - Trading venues for the purposes of trading obligation for derivatives										Y	
Art.33(2) - Derivatives: trade execution and clearing obligations											
Art.38(3) - Trading venues and CCPs-access to benchmarks and licences for the purposes of clearing and trading obligations											
Art.47(1) - Investment firms providing investment services to EU professional clients and eligible counterparties											

Table 1 – Status of activated equivalence under MIFIR as of January 2018, *Source: European Commission*

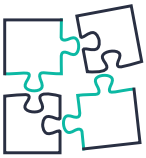
The EU equivalence regimes and cross-border banking and financial services

Allowing UK based banks and financial institutions to serve EU customers located in the EU market (and vice versa) will be beneficial for choice, competition and cost to the customer.

Allowing UK based banks and financial institutions to serve EU customers located in the EU market (and vice versa) will be beneficial for choice, competition and cost to the customer. For the same reason, it makes sound sense for the EU and the UK to consider instances where providing certain international banking and investment services directly from one market to the other should be made possible. Such cross-border access will have to depend on sound and robust assessments of the comparability of regulatory frameworks for financial services on both sides.

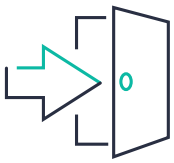
However, as noted above, while the EU's equivalence regimes facilitate a wide range of international banking and financial services activity, they were not designed or intended to operate as a comprehensive and robust framework for cross-border contracting of banking services between two markets that are as integrated as those of the UK and the EU. For example:

- Scope - The scope covered by cross-border trading rights under the EU's equivalence regimes does not include core products and services. Although the EU's equivalence regimes cover most areas of financial services in some ways, they only provide for cross-border trading rights in a very small number of areas and most of these have not yet been activated. These include some rights to market alternative investment funds and some rights to provide a range of investment services cross-border to professional customers. There is no equivalence regime for cross-border trading of core areas of banking, such as lending or credit services (including syndicated lending), payments and deposit-taking. These are all services that are currently available and widely used across the integrated EU-UK market.



- Clarity and predictability of equivalence determination - There is no established EU template for equivalence judgements. While they are in most cases based in principle on outcomes rather than line by line comparisons between regulatory frameworks, in practice the exact approach can be opaque. Most systems of recognition protect – rightly – the ultimate autonomy and discretion of a state in granting comparability judgements like equivalence. However, this does not exclude the establishment of clear and predictable criteria and a strong degree of collaboration between supervisors in reaching such determinations.

- Equivalence withdrawal - EU equivalence determinations can be withdrawn with little or no notice, and without any obligation to consult with the other party. This makes the basing of cross-border trade on such determinations inherently unstable.



Equivalence in the EU: Differing EU calls for Reform

Many in the EU have long recognised that the use of equivalence has some shortcomings, and could be reformed to foster greater benefits to EU businesses and customers

Proposals that would further restrict current equivalence should be treated with caution if not justified following an appropriate EU economic and competition impact assessment.

The challenge in applying the EU's current model of equivalence as a stable and effective basis for cross-border trade is made greater by the fact that the EU is currently debating these regimes and their purposes. The debate encompasses a broad spectrum of views, with some voices calling for a broader, more transparent and objective basis for equivalence, and others seeking a stricter, and more circumscribed approach requiring more activities to be carried out exclusively inside the EU.

In the former camp, many in the EU have long recognised that the use of equivalence has some shortcomings, can become unhelpfully politicised, lacks consistency in some respects, and could be reformed to foster greater benefits to EU businesses and customers. A recent European Parliament report on the EU's financial services relationships with third countries acknowledges many of these concerns and recognises that there may be occasions where it would be more appropriate to strike "cooperation arrangements between the EU and third countries" in order to build on the equivalence framework . The report goes on to make a number of recommendations for reform and improvement of the existing equivalence regime.

In the latter camp, this debate has also been used by some in the EU to question whether the current equivalence regime provides too much scope for cross-border market access, or whether this access is extended on terms that are not correctly calibrated to the nature of the jurisdiction being reviewed. For example:

- Policymakers in both the European Parliament and European Commission have proposed that the equivalence regime should be made more restrictive when applied to large sophisticated (so-called "high impact") jurisdictions, such as the US and, by implication, the post-Brexit UK, two of the most important suppliers of financial services to EU businesses, financial institutions, pension funds and sovereigns.
- Recent proposals for revision to the EU's market infrastructure regime anticipated a 'three tier' system for third country clearing houses. This would introduce stricter criteria for "systemically important" markets such as the US and the UK, extending in some cases EU prudential and collateral requirements, or forcing the localisation and subsidiarisation in the EU for those clearing houses deemed "too big to recognise". The creation of new resources and powers for the EU market regulator, ESMA, and for the European Central Bank has also raised the prospect of existing equivalence judgements being reopened.
- There have been Member State proposals, in the context of the current review of the prudential requirements for investment firms, to replace the existing framework under the Markets in Financial Instruments Regulation (MiFIR) with a more restrictive regime with very limited scope for cross-border provision. A draft European Parliament report on the same issue would continue to allow firms from equivalent third countries to contract cross-border with professional clients in the EU, but also proposes to significantly narrow the scope of services that could be provided under the MiFIR regime. This could, for example exclude other core banking services such as Over-the-Counter ('OTC') derivatives services (which are derivatives that are not listed and traded on a public exchange and are typically tailor-made to satisfy the specific risk management requirements of a customer), many types of trading in securities and underwriting offerings of shares or bonds for customers.

A considered approach to updating the current equivalence model to make it more transparent, flexible, sustainable and covering a wider range of products would benefit EU businesses and citizens in accessing a wider and deeper pool of capital, supporting economic growth. Proposals that would further restrict current equivalence or that would narrow the categories of cross-border services for which equivalence is available (such as the Investment Firm Review proposal described above) should be treated with caution if not justified following an appropriate EU economic impact assessment and an evaluation of any adverse effects upon competition.

[3] http://www.europarl.europa.eu/sides/getDoc.do?type=TA&reference=P8-TA-2018-0326&language=EN&ring=A8-2018-0263

Box 3: EU Equivalence Today – A Case Study of how it works in practice

How useable is the current EU equivalence regime likely to be for UK- based banks and financial institutions and the EU based customers who use their services? Unfortunately, in its current form, it would be of extremely limited use.

An example of a business user of banking services can help illustrate what this means in practice. Our example uses a mid-sized European manufacturer with operations in a number of countries and suppliers and customers across the EU, in the UK and in more distant export markets.

As is typical for the integrated supply chains of many manufacturers, these rely on a tailored mix of financial products and services to underpin their investment, risk management, and purchasing, manufacturing and sales financing needs.

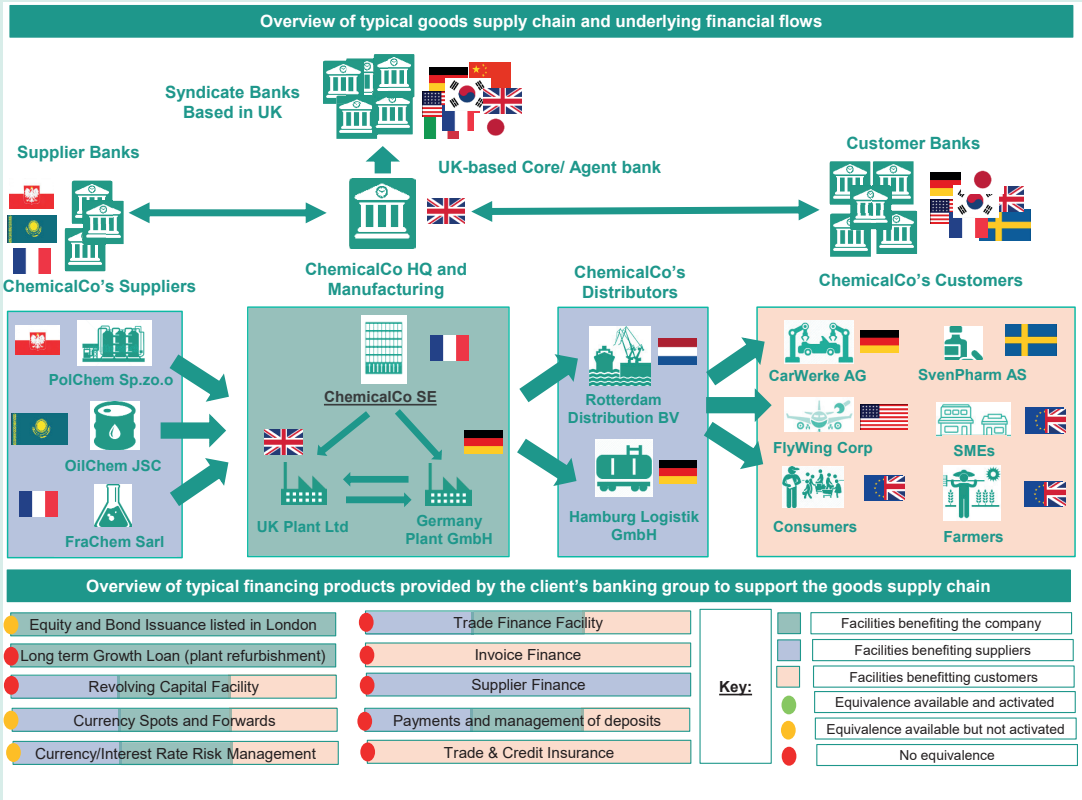
Because of the close interconnectedness among manufacturers, suppliers and end customers, some of these financial products and services can be made available to smaller suppliers and customers (such as SMEs) to provide these with financing solutions which, if seeking to obtain them on their own, they would not be able to obtain at all, or only on much less attractive terms.

Where some of these products and services can no longer be provided on an integrated basis (for example, because no 'equivalence' is available), replacing these is not simply a matter of finding an alternative provider. In many cases, the loss of or reduction in integration will mean that a number of the financial products or services can no longer be provided at all or not on similar terms. An example of such a loss could arise where a supplier or end customer of a mid-sized or large company is using their own financing provider, which would no longer have the benefit of linking to the mid-sized or large company's credit standing, or payments and transactions across the supply chain, to support the supplier or end customer's credit. As a result, the availability of financing to the supplier or end customer could be restricted and/or more costly.

A European Manufacturing Case Study

ChemicalCo SE is a mid-size chemical manufacturer based in the EU. It is headquartered in France, where its treasury operations are also located. It purchases raw materials from across the EU and from Eastern Europe. It refines these at its two refinery locations, one in Germany and the second in the UK. Its finished products are then sold to customers worldwide – across the EU, in the UK and more distant export markets in Asia, Africa and the Americas. Its customers include consumers, SMEs, farmers and manufacturers in the automotive, pharmaceutical, aerospace and heavy engineering sectors. It has used the London capital markets to raise capital from international investors via share and bond issues, listed in London.

In our example these products and services are offered to ChemicalCo, its group businesses, its suppliers and its customers, on an integrated basis by syndicates of providers led by its lead agent bank (noting that payments and deposit management are not syndicated but managed by the agent, across currencies) located in the UK and able to coordinate the mix of providers best suited for each of the services needed wherever located, whether in the UK, the EU or other international location.



To support the financing needs of its business and those of its suppliers and customers, ChemicalCo SE requires a 'one-stop' integrated service from its banks to provide a menu of products and services. These are summarised in the Appendix.

As illustrated by the above example and the table below, there is today either no equivalence or no activated equivalence regime available for many of the financing products and services commonly used by customers.

For the largest EU-based customers this may be less of a concern as these will typically use multiple financial services providers, and have the capacity to 'mix and match' these to suit their needs, as well as having treasury and other commercial locations outside the EU enabling them to retain continued access to the most attractive offerings.

However, many other customers in the EU will not have the same capacity and reach and will wish to maintain many of the benefits that the integrated service described above offers.

The below table provides a visual illustration of the products and services required by ChemicalCo and their equivalence eligibility.

Product	Passporting	Equivalence	Potential impact of current EU discussions
Revolving Credit Facility		No equivalence for borrowing and/ or deposit-taking under CRR and CRD. Although concept exists and is activated for capital treatment of banks, this is of no use to a corporate customer accessing the products.	
Deposit-taking			
Long Term Growth Loan (Plant finance)			
Trade Finance Facility			
Supplier Finance Facility		No equivalence for these types of facility under CRR and CRD.	
Invoice Finance Facility			
Payments		No equivalence for payments under PSD 2.	
Currency Spot and Forwards		There is equivalence provision under the relevant EU regime (MIFID2/MIFIR) for currency transactions that qualify as derivatives or that are ancillary services connected to other investment services and activities covered by MiFID2/MiFIR - not yet activated.	Current EU proposals would restrict the conditions on which equivalence can be granted under MiFIR. In addition, a Member State proposal would require firms from equivalent jurisdictions to provide any services via an EU branch or subsidiary and an MEP proposal would prevent firms from equivalent jurisdictions providing derivatives services as principal (overriding any more favourable national regimes allowing cross-border access to firms from those jurisdictions).
Currency and Interest Risk Management products		There is equivalence provision under the relevant EU regime (MIFID2/MIFIR) for currency and interest rate products - not yet activated. This is also linked to the issues around the recognition under EMIR of UK CCPs, which are currently used for clearing a large part of euro denominated and other currency and interest rate risk management products.	Current EU proposals would restrict the conditions on which equivalence can be granted under MiFIR. In addition, a Member State proposal would require firms from equivalent jurisdictions to provide any services via an EU branch or subsidiary and an MEP proposal would prevent firms from equivalent jurisdictions providing derivatives services as principal (overriding any more favourable national regimes allowing cross-border access to firms from those jurisdictions). Current EU proposal under EMIR requires either localisation for systemic CCPs or joint supervision of those CCPs by EU supervisors for access across all member states.
Syndication of credit facilities		No equivalence for syndication of credit facilities (including supplier and invoice finance facilities) under CRR and CRD.	
Trade & Credit Insurance		No equivalence for sale of insurance products under Solvency 2.	
Listing and Bond Issuance in London		There is equivalence provision under the relevant EU regime (MIFID2/MIFIR) for underwriting and placement of debt and equity securities as well as for secondary market trading in those securities - not yet activated.	

The national licencing regimes of certain individual EU member states may provide some relief from the limitations of EU equivalence cross-border market access regimes where e.g. the relevant product is not regulated in the member state or where the member state has exemptions or other avenues for cross-border services to be offered to customers in the member state. For more details please refer to UK Finance's report "Serving Europe - Navigating the legislative landscape outside the single market" https://www.ukfinance.org.uk/serving-europe-navigating-the-legislative-landscape-from-outside-the-single-market/

Equivalence in a future EU-UK framework for financial services: the challenges

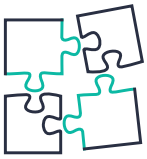
The UK and the EU need to preserve the current EU equivalence-based cross-border frameworks for trade between them as the baseline for enhancements for a post-Brexit relationship.

It is against this backdrop that the UK government has published its initial proposals for a future trading relationship with the EU in financial services. The proposal contemplates that an enhanced form of the EU's equivalence regimes will be an important part of a future trade relationship for financial services between the EU and the UK. Any such enhancement will be materially inferior to the rights available under the EU 'passport' regimes for those inside the Single Market. As independent jurisdictions which have many firms highly active on a cross-border basis in each other's markets, determining the comparability of each other's prudential rules will be an integral part of the way these firms are supervised. Such determinations can and should also form part of the basis for cross-border provision of services. However, for this to be feasible four things are important.

Baseline Stability

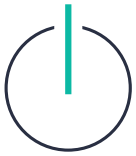
The UK and the EU need to preserve the current EU equivalence-based cross-border frameworks for trade between them as the baseline for enhancements for a post-Brexit relationship. Any proposed revisions to the current market infrastructure, Alternative Investment Fund Management and Markets in Financial Instruments regimes that would make them more restrictive than they already are should be avoided.

Scope



The scope of equivalence application for the purposes of EU-UK future relationship would need to be widened. This is especially important in areas such as corporate banking and payments services, which are governed by the EU Capital Requirements and Payment Services regimes. At present the use of equivalence in the former (for regulatory capital standards, for example) does not extend to cross-border lending or deposit taking, and the latter has no equivalence provisions. Yet these banking services are integral to any international banking service framework. Ideally, the scope of equivalence used in EU-UK cross-border contracting frameworks should be driven by the way the "most important internationally-traded" services are actually required and used by relevant EU and UK businesses or investors.

Activation



This would also mean that the existing equivalence regimes permitting the cross-border provision of certain other core products and services should be activated.

Determination

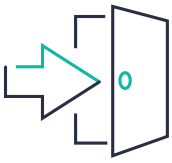
The application of the EU's equivalence regime also needs to be adapted in a number of ways. Without procedural enhancements to the way equivalence in an EU-UK relationship is determined, maintained and potentially withdrawn, there is a risk the system would be opaque and too unreliable as a stable basis for cross-border operations. Even though the ultimate equivalence judgements should remain the autonomous prerogative of the EU or the UK, this is not incompatible with an element of transparency, predictability and collaboration on reciprocal determinations.

As the EU proposed to the US in the context of the TTIP negotiations on financial services the two sides should agree a transparent methodology for determinations acceptable to both sides. For example, such determinations could be based upon objective principles relating to prudential standards and technical requirements set by regulators, avoiding politicisation where possible. They should agree that such determinations should be conducted jointly, wherever possible and appropriate. The UK government has suggested that such assessments should draw on industry consultation and mutually accepted panels of experts and these are potentially good ways of adding an element of consultation while respecting the ultimate autonomy of both sides.

[4] See UK White Paper paragraph 63

While preserving the basic autonomy of both sides, it is possible to agree a process of transparent consultation on proposed withdrawals of equivalence.

Withdrawal



The protocols for withdrawing equivalence judgements in an EU-UK relationship should also be refined and agreed to provide a much greater element of predictability for users of cross-border services based on them. While preserving the basic autonomy of both sides, it is possible to agree a process of transparent consultation on proposed withdrawals of equivalence.

Withdrawal should also only take place after due consideration of the interests of the customers that rely on the covered services, who should be given adequate time to adapt their operations. These protocols should function as an 'off-ramp' to ensure that firms and their customers that must adapt to a withdrawal of recognition and any linked market access rights should have time to make new arrangements in a way that is minimally disruptive for customers and the wider economy. They should also allow for flexibility that allows certain cross-border contracting rights to be withdrawn without cancelling a wider set of rights.

Regulatory collaboration and coordination

Protocols of this kind on equivalence determination, oversight and potential withdrawal should be underpinned by a high level of regulatory collaboration and cooperation. The EU already has an existing set of frameworks with its key external trading partners which could serve as useful models: the enhanced regulatory forum with the US, the regulatory forums envisaged under the EU-Canada and the EU-Japan free trade agreements and the prudential risk management groups established between EU and US supervisors.

Enhancing Equivalence: how to achieve it

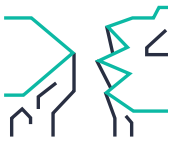
An orderly exit means ensuring that equivalence determinations are in place at the point at which the UK exits the single market for financial services.

How these issues are resolved is an integral part of the wider challenge of ensuring an orderly UK exit from the EU single market for financial services. Expanding the scope of EU and UK equivalence regimes so that they can support cross-border contracting in international banking services is a critical step in ensuring that some of the mutually beneficial cross-border arrangements available today are preserved where politically acceptable and economically desirable.

Day 1 Equivalence

An orderly exit means ensuring that those rights and the equivalence determinations that underpin them are in place at the point at which the UK exits the single market for financial services.

This implies that such judgements will need to be made in parallel to the negotiation of a future framework itself before exit, or be covered by temporary arrangements while they are finalised after exit. In the absence of such provisions both EU and UK based firms may find themselves subject to highly disruptive lapses in capital or regulatory reliefs, new regulatory requirements or lost cross-border rights. This 'hiatus risk' is no different in its practical effect than a 'cliff edge' sudden exit from the current passporting regime[5].



This 'hiatus risk' is not a theoretical concern. The EU has historically taken the position that its equivalence determinations can only be commenced and carried out for a country that is a third country. This would imply that these could not be deployed while the UK is a member of the EU (up to the end of March 2019) or during any transition period (proposed to continue to December 2020). At present the design of transitional arrangements appears to present a challenge in this respect. This is because they require that the UK continue to

[5] In the EU-Canada CETA agreement the EU and Canada agreed that cross border market access rights for certain investment portfolio management services would be contingent on an equivalence judgement from the EU provided within four years. This is a useful example of how equivalence can be used as a tool in a bilateral agreement, but similarly prospective commitments in an EU-UK agreement would be inappropriate as they would risk a cliff edge lapsing of cross-border contracting rights.

It is important to approach this question from the perspective of real-world implications and the interests of service users in both the EU and the UK.

be treated in almost all respects as an EU member state during a transitional period. While this is a necessary provision in most respects, it raises the question of how equivalence judgements should be completed where these can only legally be determined for third countries.

This risk could be avoided through a specific legal solution in a Withdrawal Agreement that specifies that equivalence determinations by both sides can and should proceed in an expeditious way even while the two sides are not technically treating each other as third countries. Such equivalence determinations should be facilitated by the simple fact that the EU and UK regulatory regimes are identical in all material respects, and that the UK has committed to maintaining that policy alignment at the point of exit. Alternatively, the Withdrawal Agreement should provide temporary arrangements in the period following the UK exit to allow these judgments to be made and applied after exit without disruption.

Changing Scope, Determination and Withdrawal process

Implementing needed enhancements to equivalence between the EU and the UK, from its scope, through to how it is determined and withdrawn, requires legislative and regulatory change in both jurisdictions and presents a negotiating challenge. With both sides privileging their autonomy in this area before negotiations have even started it is important to approach this question from the perspective of real-world implications and the interests of service users in both the EU and the UK. That means starting from an ambition to preserve valuable cross-border flows of services, and not from a fixed view that autonomy must mean no change in regulatory frameworks.

How such commitments to legislative and regulatory change are ultimately made remains a question for the two sides to agree.

In principle, two broad approaches are available to achieve this, one emphasising the highest degree of autonomy and independence, and the other contemplating a greater level of cooperation and coordination.

- The former would have as its basis each of the EU and UK following their domestic regimes for adoption of new legislation. While this has the advantage of clearly preserving the regulatory autonomy and sovereignty that both have emphasised remain key priorities, the recent EU experience suggests that it risks being slow and less coordinated with a potentially high degree of 'hiatus risk'.
- The latter would have as its basis a mix of binding commitments in an EU-UK Free Trade Agreement ('FTA') or Association Agreement, unilateral legislative and regulatory change and regulatory and supervisory cooperation, or a combination thereof. This approach would likely involve a considerably lower degree of 'hiatus risk' while still enabling the fundamental autonomy and sovereignty of both the EU and the UK to be protected. If there were concerns that the latter approach would provide a preferential treatment for entities located in the UK and EU as compared to other third countries these should be regarded as temporary differences that could be dealt with in due course by 'catching up' and aligning other third country regimes.

"... After 29 March 2019, the United Kingdom will never be an ordinary third country for us.

The United Kingdom will always be a very close neighbour and partner, in political, economic and security terms. In the past months, whenever we needed unity in the Union, Britain was at our side, driven by the same values and principles as all other Europeans.

This is why I welcome Prime Minister May's proposal to develop an ambitious new partnership for the future, after Brexit ..."

Jean Claude Juncker, President of the European Commission, Authorised version of the State of the Union Address 2018, September 2018

Summary: 'enhanced' equivalence in a future EU-UK relationship

While the EU has developed a sophisticated system for assessing the regulatory comparability of non-EU financial services jurisdictions, this framework as it currently operates would be far from ideal as the basis for a future trading relationship in financial services between the EU and the UK. However, a range of enhancements and some important contingency planning steps would make it more feasible as a starting framework for using the existing tool of equivalence recognition to create a deeper, more robust relationship for financial services trade than the EU or the UK is likely to have with any other partner – while preserving the ultimate autonomy of both sides.

The most important of these enhancements relate to the scope of the current EU equivalence regime's coverage of cross border trade and the timely activation of the relevant regimes enabling cross-border trade coverage, the transparency, consistency and collaboration with which equivalence determinations are reached and the protections for businesses and their customers that are built into the protocols for withdrawing equivalence determinations.

There also needs to be specific provision for ensuring that any and all equivalence determinations possible between the EU and the UK are made and are operational at the point the UK leaves the EU single market, even in case of a no deal scenario.

In principle, these enhancements and contingency planning steps could be applied through a mix of binding commitments in an EU-UK FTA or Association Agreement, unilateral legislative and regulatory change and regulatory and supervisory cooperation, or a combination thereof.

This can, and should, be done while protecting the fundamental autonomy and sovereignty of both the EU and the UK regardless if an agreement has been reached on the terms of the UK's withdrawal from the EU, or the future relationship between the EU and the UK, or if the two are facing a no-deal scenario.

This should be the aim of both sides.

APPENDIX - Integrated Financial products and services used by ChemicalCo to support its supply chain and economic ecosystem

Products and Services to support ChemicalCo's manufacturing activities:

- Revolving Credit Facility that enables ChemicalCo to access short term credit. This should be available in a range of currencies including dollars, euros and sterling to allow ChemicalCo to meet obligations in any of its markets of operation;
- Deposit management services - which allow it to move its deposits where they are needed, when they are needed, across currencies and borders, to limit need to use, and minimise the cost of, financing.

Products and Services to support ChemicalCo's supply chain with both its suppliers and its customers:

- Trade Finance credit facility in dollars, euros, sterling, yen and other currencies required for its suppliers and customers, allowing ChemicalCo to accelerate deliveries with import guarantees and letters of credit, optimise logistics and payment of customs duties and other taxes, win long term contracts and finance inventories;
- Invoice and Supplier Finance across multiple currencies, allowing Chemical Co to raise credit against invoices and expedite settlement of supplier invoices. This is especially beneficial for smaller suppliers and customers such as SMEs as it allows these to benefit from faster payments and superior credit terms, especially when combined with Trade and Credit Insurance services or government export credit support, which is available because of the ability to connect seamlessly the commercial and financial flows from supplier to ChemicalCo and from ChemicalCo to its customers;
- Payments services allowing ChemicalCo to receive and make payments in the currency of the supplier or its customers and to offer direct debit, direct credit and electronic payments to consumers and small businesses buying from it;
- Trade and Credit Insurance Services helping ChemicalCo move the risk of non-payment by small businesses customers to insurers. This allowsChemicalCo to sell more, on longer payment terms, to SMEs and small businesses that would otherwise either have to purchase on advance payments, or very short sale terms, or not be able to purchase at all.

Products and Services to support ChemicalCo's long term investment requirements:

- Long term growth loan credit facility in euros and sterling to for the refurbishment and expansion of its refineries in Germany and the UK allowing it to meet environmental protection requirements while expanding economic activity and investing in R&D;
- Share and bond issues listed in London to access international investors to provide capital on a longerterm basis than is typically available from banks and to access a broader group of international investors.

For all of these Chemical Co will also use Risk Management products such as interest rate or foreign currency hedging to manage the risk of volatility, and bring down its overall cost of doing business.

See also

BQB # 1 Staying in or leaving the EU Single Market.
BQB # 2 An orderly exit from the EU.
BQB # 3 What is 'passporting' and why does it matter?
BQB # 4 What is equivalence and how does it work?
BQB # 5 Data protection and transfer
BQB # 6 Time to adapt – the need for transitional arrangements.
BQB # 7 The Repeal Bill - providing certainty and continuity
BQB # 8 External trade policy and a UK exit from the EU - clarifying the UK's WTO profile and beyond.
BQB # 9 Impact of Brexit on cross-border financial services contracts
BQB # 10 Towards a framework for financial services in an EU-UK Trade Agreement
BQB # 11 No interruptions: options for the future UK-EU data-sharing relationship

Acknowledgements and contacts

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UK Finance

UK Finance represents nearly 300 of the leading firms providing finance, banking, mortgages, markets and payments related services in or from the UK. UK Finance has been created by combining most of the activities of the Asset Based Finance Association, the British Bankers' Association, the Council of Mortgage Lenders, Financial Fraud Action UK, Payments UK and the UK Cards Association. UK Finance has an important role to play helping negotiators understand how the interests of UK and EU customers, and the financial services they all depend upon, can be best protected. Our members are large and small, national and regional, domestic and international, corporate and mutual, retail and wholesale, physical and virtual, banks and non-banks. Our members' customers are individuals, corporates, charities, clubs, associations and government bodies, served domestically and cross-border. These customers access a wide range of financial and advisory products and services, essential to their day-to-day activities. The interests of our members' customers are at the heart of our work.

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Global Counsel works with clients navigating the critical area between business, politics and policymaking, we help companies and investors across a wide range of sectors to anticipate the ways in which politics, regulation and public policymaking create both risk and opportunity – and to develop and implement strategies to meet these challenges.

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