UK FINANCE

What is ‘equivalence’ and how does it work?

Key points

- When assessing the operational rights or treatment of foreign banks in the EU the EU assesses whether the standards of regulation and supervision in a bank’s home market are ‘equivalent’ to those of the EU.
- A determination of equivalence can be beneficial for a foreign bank or for an EU bank dealing with a foreign bank (or foreign stock exchange or central counterparty for clearing securities transactions (‘CCP’)). The benefits are not uniform and can vary considerably depending on the EU legislation under which equivalence is given. Typical advantages could include (i) granting foreign banks limited market access rights inside the EU for certain services, (ii) more favourable treatment for branches of foreign banks located in the EU, or (iii) more favourable treatment for EU banks having exposures to a foreign bank, stock exchange or CCP.
- Equivalence is not a substitute for the operational rights created by the EU passporting system for banks. It operates in fewer areas, covers fewer services and is inherently less secure. Some of the more significant equivalence regimes for foreign banks will not come into effect for several more years.
- Equivalence is determined in different ways in different areas. It is based not on exact transposition of EU laws, but on a comparison of the intent and outcome of laws. In some cases, the EU will require that another country extend reciprocal recognition as a condition of granting equivalence.
- Equivalence is not negotiated, but requested. Assessments are launched at the EU’s discretion. It can also be withdrawn, along with any rights that depend on it, at the EU’s discretion if a country is judged to have diverged from EU standards for any reason.
- However, a country granted equivalence is not obliged to mirror changes to EU law if it does not wish to – subject to a potential loss of rights.
- Some commentators have suggested that the granting of equivalence inevitably involves both technical and political considerations.
- It was recently reported that the EU is re-examining existing equivalence rules with an eye to streamlining and strengthening the approval process so it is more rigorous for systemically relevant jurisdictions.

UK Finance Quick Briefs are a series of short papers intended to inform readers about key commercial, regulatory and political considerations around Brexit. While they are focused on banking, many of the issues discussed have wider relevance. Each BQB may be read on its own or in conjunction with other papers in the series. It is intended to expand the series as further topics of significance are identified.
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International trade and equivalence

A fundamental principle common to all international trade is that where a country wishes to sell its goods or services into another country, its products should conform with the standards and regulations of the country to which it wishes to sell. Over the years, trading countries have recognised that aligning standards as much as possible can make a useful contribution to encouraging imports and exports. World Trade Organisation (WTO) agreements such as the Technical Barriers to Trade Agreement, signed in 1995, encourage all WTO members to develop systems for recognising the regulatory standards of other WTO members in order to facilitate trade.

Many such agreements on recognising the systems of others have been developed by WTO members over the years. Sometimes these frameworks take the form of agreements to allow licensing or testing authorities to carry out product assessments on behalf of the authorities in a market of export, creating confidence for an exporter. An alternative system uses the concept of 'equivalence', in which one country declares that the standards of another in a defined area are sufficiently close to its own to be deemed 'equivalent'. This approach has been pioneered and developed by the EU.

A level playing field and robust rights

Equivalence has an important role in financial services trade with the EU.

Equivalence has an important role in financial services trade with the EU. In banking, the EU uses equivalence judgements for two main purposes. The first is as the basis for granting a non-EU bank certain rights in the EU market. The second is in defining the rights and regulatory treatment of EU banks when they operate in a market outside the EU.

In some cases, equivalence is used as the basis for market access rights in the single market, but in many cases it is not linked to market access rights in this explicit way, providing instead for reliefs from the general treatment of foreign firms or regimes. Some important examples of the way the EU uses equivalence in banking and related areas are:

- In assessing the regulatory standards in their home market of non-EU banks that operate branches in the EU. These judgements are often reflected in the way in which EU supervisors treat foreign branches and determine any additional requirements they may impose on them. One important use of these judgements is in determining how to assess the risk posed by EU banks taking exposures to banks in these markets. Equivalence judgements are also used by insurance regulators to assess the level of risk represented by the operations of EU insurance companies in non-EU markets.
- In assessing the standards that apply to market infrastructure in countries outside the EU, especially central counterparties for clearing securities trades. These judgements are used to determine how freely EU firms can use these market services to meet their obligations to clear and report trades (see Box 1: Equivalence in practice).
- In assessing the data protection standards of non-EU countries. These judgements are used to determine how freely the personal data of EU citizens can be moved by banks (and other companies) to these countries for processing or storage.
- In the second Markets in Financial Instruments Directive (MIFID II) and its linked Regulation, the EU has proposed to create a market access framework for certain investment businesses that would allow them to sell from outside the EU certain market services such as investment advice and support in designing, buying and selling securities - once their home market has been judged equivalent by the EU. This framework is still being implemented and these provisions have not yet been activated for any country.

Box 1: Equivalence in practice: the EU, the US and the Chicago Mercantile Exchange.

Under the EU’s existing procedures, securing equivalence can be complex, messy 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).

CCPs play an important role in derivatives markets acting as a middle-man 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.

This system is based on assessing the equivalence of market infrastructure rules in other countries where EU firms wish to use CCPs. Once the market framework has been given the EU seal of approval, the European market regulator ESMA must then approve each individual CCP in that market seeking recognition. While EU businesses can still use a CCP that has not been ‘recognised’ under EMIR, doing so comes with potential additional risk management cost and obligations. Banks exposed to transactions on unrecognised CCPs have to hold more capital.

Since 2012 the EU has assessed a number of CCP frameworks around the world and recognised a number of individual CCPs in these markets. In most cases these took a number of years to complete. However, it proved particularly complex when the question 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 protecting them against movements in US interest rates.

- Once the EU’s assessments of US CCP rules began, it became clear that US and EU rules in key areas were quite different. 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, and a deadline for an agreement was ultimately pushed back twice in 2016. At one point, the leadership of the CME, frustrated with the EU’s approach to recognition, called for EU firms to be barred from US CCPs.
- 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. The US did this in March 2016 via the ‘substituted compliance’ procedure it uses to recognize the supervisory standards of other countries to assess the treatment of US firms operating there. The US process for this mutual recognition was also highly criticized and time consuming to achieve.

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. It will also need formal systems for recognising the equivalence of EU rules with its own.

How is equivalence determined

Aligning a country's rules closely with those of the EU does not in itself guarantee treatment as equivalent by the EU. Nor does a judgement by the EU of equivalence automatically create rights to trade in the EU for firms from that country.

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 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.

So 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. Nor does a judgement by the EU of equivalence automatically create rights to trade in the EU for firms from that country. This depends on the specific use that the EU framework makes of equivalence.

In some cases, equivalence judgements are made at the EU level, by EU authorities. In others, the equivalence judgement is left to national supervisory authorities in the EU. This is the case for judgements of the home regulation of branches of foreign banks in the EU, which are solely supervised at the national level

In some cases, the EU uses the recognition of equivalence to determine the treatment of certain kinds of business that EU banks carry out in the foreign country. This is the case for equivalence judgements that reflect the way that firms are regulated when they have operations in other countries or when banks lend or borrow to banks or other firms in that country. For example, when EU-based banks enter into transactions with banks in countries that have been found equivalent by the EU for the purposes of prudential bank regulation they may generally hold less capital against that risk than for banks from countries that have not. In other instances, EU regulators use the same recognition of equivalence of a non-EU country to shape how they regulate EU branches of banks from that country. A judgement of this sort on the UK would be very important for both EU and UK banks if UK-based banks were to continue to provide wholesale lending to banks inside the EU.

However, there is no equivalence regime applicable for the EU's core banking rulebook – the Capital Requirements Directive (CRD IV). CRD IV applies to core bank services such as lending and deposit taking. This is one of the most important practical distinctions between the breadth of the EU passporting system for EU banks, and the more restrictive treatment of non-EU banks under the limited equivalence frameworks.

The EU has proposed, but not yet implemented, a small number of equivalence regimes that would permit a non-EU bank to sell certain cross-border services directly into the EU subject to equivalence. One of these is MiFID II. This covers a range of investment services, including the design, sale and trading of securities and the provision of investment advice, all central functions of a modern investment bank. However, the services covered by the equivalence framework in MIFID II are significantly narrower than the services covered by the MiFID passport.

Table 1: Passporting and equivalence compared: five key EU banking frameworks

	Service, Product or Activity covered	Single market access via passport?	Single market access via equivalence?	Who decides equivalence?
The Fourth Capital Requirements Directive (CRD IV)	Core bank services such as lending and deposit taking and corporate banking advisory services.	Yes, cross border rights across the single market and local treatment for branch operations	No, While the recognizes third countries as equivalent with CRD IV for certain reasons, this confers no market access rights for non-EU banks.	No equivalence regime
The Second Markets in Financial Instruments Directive (MiFID II)	A range of investment and market services, including the design, sale and trading of securities and the provision of investment advice.	Yes, cross border rights across the single market and local treatment for branch operations.	In principle, MiFID II creates cross border market access rights for non-EU firms, once authorized by ESMA, but only covering some MiFID services. However, this system has not yet been activated.	A combination of: ESMA, the European Commission and EU Council.
The Second Payments Services Directive (PSD II)	Payments services.	Yes, cross border rights across the single market.	No, PSD II has no market access framework for non-EU service providers	No equivalence regime.
The UCITS Directive	The design, management and distribution of collective investment products.	Yes, cross border rights across the single market.	No, UCITS funds can only be managed and marketed from inside the EEA	No equivalence regime.
The Alternative Investment Fund Managers Directive (AIFMD)	The marketing, and management of alternative investment funds.	Yes, cross border rights across the single market.	In principle, AIFMD creates cross border rights for non-EU firms, with equivalence and once authorized by ESMA, but no country has yet been recognized as equivalent.	A combination of: ESMA, the European Commission and EU Council.

Equivalence differs from passporting

For more on passporting see Brexit Quick Brief # 3 What is 'passporting' and why does it matter?

Some commentators have suggested that 'equivalence' assessments could provide non-EU banks or financial institutions with substantially similar market access to serve customers in the EU to that available under the passport regime available to banks and financial institutions within the EU. This is not correct. The EU market access rights available under equivalence assessments are narrower, more onerous and more unstable, and many banking services or other financial services cannot be provided at all via equivalence.

Box 2: Equivalence and passporting compared.

How much of a solution are the EU's current equivalence regimes for the loss of passporting rights for the UK? For the kind of services provided by many UK-based banks in the EU, they are a limited solution at best. To illustrate passporting, in Brexit Quick Brief #3 we used the example of a UK-based bank helping to arrange a syndicated loan and a bond issue on the international capital markets for an EU company wishing to build a new factory. As part of this transaction, the UK-based bank also helped the EU firm hedge some of its currency and interest rate risk with a derivatives position. To provide these closely integrated banking services to its customer the UK bank depended on its EU CRD IV and MiFID passports.

Could it conduct the same set of integrated transactions via equivalence regimes? No, it could not:

- It could not provide advisory services for the loan to the EU firm from the UK, as there is no equivalence-based alternative to the CRD IV passport in the EU.
- It could not provide the syndicated loan service from the UK, as there as there is no equivalence-based alternative to the CRD IV passport in the EU.
- If the EU had activated the proposed MiFID II third country framework for the UK and if UK equivalence had been established in this area and if the UK bank had been additionally authorised by ESMA, then the bank could potentially provide the loan issue and the derivatives services. If the UK had not been recognised by the EU in this respect, it could not.

Similar impediments arise for other kinds of integrated banking services. For example, if the founder of the EU company approached the same UK bank for personal banking and investment advice for his/her family the bank could not provide basic banking services to the client in the EU from the UK as there is no equivalence-based regime for CRD IV. It could not provide investment services, even if the UK were covered by the proposed MiFID II equivalence regime, because that regime will not cover retail clients.

In most cases, the current equivalence-based market access and operational regimes of the EU are of limited value to the UK-based bank in providing services that it conducts freely under the passporting system. The only alternative in most cases at present is for the bank to establish new operations inside the EU to do this business.

The process for obtaining equivalence

Any such arrangement would mean aligning UK standards with those of the EU to a significant degree.

Securing an equivalence judgement from the EU can be a time-consuming and complicated process potentially lasting a number of years. Nor is it entirely divorced from political considerations. Where a judgement of equivalence is made at the EU level, it generally proceeds through a number of similar steps:

- The EU decides to review equivalence in the area of relevance for a defined country at its discretion;
- The European Commission then carries out a detailed assessment of the regulatory regime of the third country, covering both core and supporting legislation;
- The detailed assessment will often be supported by technical analysis from the relevant European Supervisory Agency;
- If it reaches a determination of equivalence then this judgement must be endorsed by EU member states, often in accordance with the EU’s Examination Procedure;
- In some cases, individual businesses must then seek their own authorisation from the relevant EU Supervisory Agency before they can take advantage of any rights conferred by the equivalence judgement – this process in itself can take a number of months.
- In some cases the other country must also extend mutual recognition to the EU as a condition for the EU equivalence authorisation.

If the equivalent country changes its rules in a way that materially affects a judgement of equivalence, equivalence and any rights based on it can be removed. This can also result from the EU changing its own rules.

It was recently reported that the EU is re-examining existing equivalence rules with an eye to streamlining and strengthening the approval process so it is more rigorous for systemically relevant jurisdictions.

Brexit, the UK and equivalence

For the UK as a country outside the EU, seeking market access or operational rights in the EU single market based on judgements of equivalence will mean weighing different political and policy priorities. These apply to both existing equivalence frameworks such as the EMIR regime and the proposed third country equivalence framework in MiFID II, which has never been used, but which could in principle be activated for the UK. They would also apply to any future market access framework between the EU and the UK for financial services based on some form of equivalence or other mutual recognition.

Any such arrangement would mean aligning UK standards with those of the EU to a significant degree, at least as long as the UK wished to maintain cross border market access or operational rights for firms based in the UK. Being judged equivalent is not the same as transposing EU law and equivalence would not bind the UK permanently. Once found equivalent by the EU a country is not committed or obliged to leave rules unchanged or mirror changes in EU rules. The UK discretion to change rules would remain, subject to the recognition that market access or operational privileges may be lost as a result.

For the UK, this will mean balancing the benefits of preferential treatment in the EU market against the reduced autonomy implied by the need to keep the UK regime sufficiently closely aligned with that of the EU in key areas. In many areas such as prudential regulation where the EU and the UK are both bound to some degree by multilateral standards this may be of limited concern. In areas where there is greater scope – or desire - for divergence in approach it will be a more delicate balance.

For banks and financial firms, market access rights based on equivalence can raise additional issues. The most acute concern is the inherent risk in basing market access freedoms on a framework that can be unilaterally removed if two regulatory regimes diverge for any reason.

Table 2: Relying on equivalence after Brexit

Pros	For UK-based banks: • Some limited market access or operational rights in the EU. • Some limited rights for EU banks to trade in the UK or with UK-based banks. For the UK • May facilitate the use of the UK as a base for exporting financial services to the EU – in the limited areas where equivalence-based market access rights apply.
Cons	For UK-based banks: • Granting of equivalence always uncertain. • Activation for the UK of key equivalence regimes such as the proposed MIFID third country framework uncertain. • Equivalence-based market access frameworks are not available for most areas currently covered by EU passports. • Loss of equivalence can materially affect operational or market access rights. For the UK • Some loss of regulatory freedom. Maintaining stability for UK-based firms trading with the EU means committing to sufficient alignment with EU rules now and in the future.

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 # 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