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The EU equivalence regime in financial services: an effective instrument to preserve financial stability after Brexit?

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Abstract

Although the UK financial sector may lose access to the Single Market as early as 31 December 2020, the EU and the UK seem miles away from a common agreement on the regulation of cross-border EU/UK financial services. One possible solution to avoid market fragmentation is to use the EU's equivalence regime: on the basis of a European Commission decision, the UK financial sector could continue to provide certain financial services to EU clients. The present policy brief analyses recent legislative reforms to the EU equivalence regime, and investigates to what extent equivalence is fit for the purpose of promoting EU financial stability (and competitive financial markets) in the post-Brexit context. The analysis shows that the relationship between equivalence and EU financial stability is not clear, as the former brings both benefits and shortcomings to the latter. On one hand, equivalence disincentivises UK financial institutions to relocate in the EU, forcing EU supervisory authorities to heavily rely on UK regulators to identify and manage systemic risks. On the other hand, equivalence can also be employed by the EU to influence UK financial rule-making and, following recent reforms, to supervise UK financial institutions providing services to EU clients. The policy brief argues that it is time for a wide-ranging reform of the EU equivalence regime, replacing the patchwork of different regulatory requirements and supervisory procedures with a single, coherent framework for all the regulated activities covered by equivalence. This would increase the international competitiveness of the Single Market for financial services, provide third country institutions with a single point of access and strengthen the supervisory powers of the ESAs and the ECB.

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[2] At the time of drafting this report, Francesco Pennesi was a Visiting Researcher at ECMI.

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The regulation of cross-border financial services after Brexit: the role of equivalence.

At last, it has happened. On 31 January 2020, the UK officially became a "third country". However, EU law will continue to apply to the UK and UK financial markets until the 31 of December 2020, a "transition period" during which the EU and the UK must find a solution for cross-border regulation of financial services.[3] The two parties can still find an agreement within the future EU/UK Free Trade Agreement (FTA) or through a bespoke deal exclusively covering financial services. If they cannot reach (an increasingly difficult) solution, however, the City of London and more generally UK-based financial institutions will lose access to the Single Market.

EU law allows EU-based financial intermediaries to operate in the entire European Economic Area (EEA) on the basis of the same licence, under various passport regimes. After the end of the transition period, this will no longer be possible, as passporting rights are reserved to financial institutions legally incorporated in EEA member states. EU-UK cross-border financial trade, which was previously governed by EU single market law, will be regulated by the General Agreement on Trade in Services (GATS) and any third country regime in force in UK and EU law. This has been fully acknowledged by both sides, who made a political commitment to respect the "Parties' regulatory and decision-making autonomy, and their ability to take equivalence decisions in their own interest. This is without prejudice to the Parties' ability to adopt or maintain any measure where necessary for prudential reasons".[4] This suggests that, unless they relocate to the EU, UK financial firms will be able to access the Single Market only through unilateral equivalence decisions adopted by the EU Commission on the basis of EU secondary legislation.

But what is equivalence? Under the equivalence regime, the European Commission can recognise the regulatory framework of a third country and thus allow financial entities originating therefrom to provide services in the Single Market, provided that this is foreseen in the relevant EU rules governing a particular financial service or product (Lannoo, 2016). Back in 1989, when the concept of equivalence was first introduced in the second banking directive, it was engineered by the EU as a tool to ensure that the freedoms of the Single Market would not be asymmetric, i.e. that third country firms would not have "more equal" access to the EU market than EU firms in third countries. In the aftermath of the financial crisis, the EU equivalence regime acquired a central role in EU financial regulation, becoming an important tool to prevent the double application of "equivalent" standards to cross-border financial activities, coordinate financial regulation with other jurisdictions, and avoid extraterritoriality. However, equivalence was never established to regulate cross-border trade in financial services with a former EU member state, particularly one hosting the main European financial hub. The

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[3] The transition period can be extended by agreement of the EU and the UK for 12 or 24 additional months, although the UK government claims it will not seek an extension.

[4] See the political declaration attached to the Withdrawal agreement. https://ec.europa.eu/commission/sites/beta-political/files/revised_political_declaration.pdf.

question therefore arises whether it is fit for the purpose of unplugging London from the continent and solving some of the regulatory challenges brought upon by Brexit.

The first factor to be considered is that equivalence may only play a role when the framework is available under EU law. After Brexit, the UK financial sector will lose access to the Single Market previously available to it under the various passport regimes. Equivalence rules, however, can substitute the passport only to a limited extent, it being available only for certain regulated activities.[5] Provisions for third country access regarding financial services and products range from being completely absent to very extensive. Among the over 40 different legislative measures comprising the EU rulebook for financial services, only 17 allow foreign market actors to access the Single Market, provided an equivalence decision is taken by the European Commission. Further, each equivalence regime establishes a different supervisory procedure to be relied upon by foreign economic actors seeking to provide services in the EU. Finally, cross-border market access under equivalence is dependent on a unilateral decision of the Commission, which can be withdrawn at any time. This makes trade liberalisation under equivalence inherently unstable.

Given those shortcomings, the UK financial industry may be legitimately reluctant to rely on equivalence to continue its operations in the Single Market. For the same reasons, the EU has so far warned UK market actors to not rely on equivalence, encouraging them to relocate their operations involving EU clients in the EU-27 in order to preserve passporting rights. Despite these important limitations, the potential role of equivalence in the context of Brexit should not be underestimated. Equivalence is a powerful regulatory mechanism to promote cross-border liberalisation in financial services, especially in the area of capital markets, given the transnational and cross-border nature of market-based finance. Within this field, the Commission can grant ‘passport-like’ market access to the Single Market to foreign central counterparties and trade repositories (EMIR), investment firms (MiFIR), alternative investment funds (AIFMD), credit rating agencies (CRAR), central securities depositories (CSDR) and trading venues (MiFID II/MiFIR). Equivalence makes the services provided by those foreign entities available to EU clients, enhancing competitiveness and liquidity within the Single Market. In certain cases, a positive equivalence determination also alleviates the regulatory and capital requirements with which EU financial firms must comply to provide cross-border services or to use a financial infrastructure in third countries.[6] In general, equivalence rules have the two-fold scope to facilitate *access* – the capacity of non-EU economic actors to operate in the Single Market – and *export* – the capacity of EU financial institutions to extend their business in foreign markets (Moloney, 2017). Given the breadth and cross-sectoral nature of the EU equivalence regime, it is to be expected that at least a part of the cross-border financial activities between the EU and the UK will be regulated by this mechanism.

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[5] For a review of the financial activities regulated under EU law covered by equivalence, see Lannoo (2016).

[6] For example, EU banking rules allow EU based financial institutions to apply preferential risk weights to capital exposures in foreign jurisdictions whose banking regime is considered equivalent to the EU. See Art. 107(4), 114,115,116 and 142 of the Capital requirements regulation (CRR).

The three phases of the EU equivalence process: assessment, review and withdrawal.

As the post-crisis EU regulatory framework consolidates, the EU has extensively employed equivalence in its financial relationship with third countries, adopting around 280 equivalence decisions for more than 30 countries.[7] The EU equivalence process always starts with the assessment of the third country regime, carried out by the Commission on the basis of the technical support of the competent ESA. Third countries should not only have a regulatory regime equivalent to EU law, but also an effective supervisory system whereby financial rules are properly implemented and enforced. Foreign authorities must also cooperate and exchange information with EU supervisory authorities, concerning cross-border financial activities taking place in the Single Market under equivalence. In certain cases, EU law also requires reciprocity: the third country concerned must be able and willing to reciprocate the market access effects of equivalence, thereby granting preferential treatment to EU financial institutions in its home markets.[8] Finally, in exceptional cases, the Commission can also require third countries to uphold specific regulatory and supervisory conditions which are not expressly mentioned under the relevant EU legislation.[9]

However, the Commission does not require third countries to copy-paste EU financial regulation, as the equivalence assessment is an "outcome based" process. Foreign regulation does not need to be identical to the EU rulebook, it only needs to achieve the same regulatory and supervisory results. For example, the recital of the European Market Infrastructure Regulation (EMIR) states that a "system should be considered equivalent if it ensures that the substantial result of the applicable regulatory regime is *similar* to Union requirements".[10] The Commission takes a "country by country" approach to equivalence, applying the EU legal principal of proportionality during the assessment. The level of regulatory alignment with EU standards required by third countries depends on the "systemic impact" that an equivalence decision may have on the Single Market for financial services. Third countries whose level of financial interconnectedness and geographical proximity with the EU is higher are expected to show closer regulatory alignment than other jurisdictions.[11]

An equivalence decision attests regulatory compatibility in a precise moment of time. Given the fast-paced nature of finance and the need to continuously adjust financial regulation to market

[7] All the equivalence decisions adopted by the European Commission can be found here: https://ec.europa.eu/info/files/overview-table-equivalence-decisions_en.

[8] EU law does not always establish reciprocity as a binding requirement in every equivalence regime. However, the Commission rarely grants equivalence access to third countries without reciprocity, as this would put the EU financial industry at a disadvantage.

[9] For example, conditions were included in the decision granting equivalence access to US Central Counterparties (CCPs) supervised by the CFTC. See the conditions attached to the Commission implementing decision (EU) 2016/377 of 15 March 2016 on the equivalence of the regulatory framework of the United States of America for central counterparties that are authorised by the Commodity Futures Trading Commission to the requirements of Regulation (EU) No 648/2012 of the European Parliament and of the Council.

[10] Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories, Recital 7.

[11] See for example, the Commission's staff working paper (EC, 2017), as well as the political communication that explains the equivalence approach including in the assessment of third countries (EC, 2019).

developments, the Commission and the ESAs monitor whether third country regimes remain equivalent over time. Before Brexit, the Commission was not systematically monitoring already adopted equivalence decisions, simply taking stock of regulatory reforms in equivalent countries through the various discussion forums established between the EU and financial partners, such as the EU-US and the EU-Switzerland regulatory dialogues on financial regulation. However, the departure of the UK has convinced the EU to reinforce its capacity.[12] The EU legislator has recently mandated the ESAs with the competence to verify the market, regulatory and supervisory effects of EU equivalence decisions on the Single Market, and the level of compliance of equivalent third countries with equivalence requirements. The ESAs must report those findings to the European Council, the European Parliament and the European Commission.[13] Moreover, the Commission has promised to periodically review already adopted equivalence decisions; such reviews will see it assessing once again the regulatory regime of a third country previously recognised as equivalent.

If, as a result of those monitoring and reviewing activities, the conditions for which equivalence was originally given are no longer present, the Commission can withdraw an equivalence decision. When a decision is withdrawn, foreign market actors previously operating under equivalence rules are suddenly prevented from servicing EU clients. This for example occurred last summer as regards the credit rating agency regime. Equivalence-based access was withdrawn for several third country jurisdictions after they failed to adjust their regulatory framework to the latest EU reform of the Credit Rating Agency Regulation.[14] However, the withdrawal of the equivalence regime for Swiss stock exchanges had by far the most political resonance. The Commission made equivalence access for the exchanges on a political agreement over the future relationship between the EU and the country. When the Swiss Parliament refused once again to ratify the wide agreement, the Commission decided to let the 'time-limited' equivalence decision in favour of the country's exchanges to expire.[15]

Will the EU and the UK recognise each other as equivalent after the transition period?

In the recently agreed revised political declaration, the EU and the UK have undertaken the commitment to "start assessing equivalence with respect to each other as soon as possible after the United Kingdom's withdrawal from the Union, endeavouring to conclude these assessments before the end of June 2020".[16] This means that both parties will be involved in

[12] The need to properly monitor already-adopted equivalence decisions has been highlighted as a priority by the European Commission (EC, 2019).

[13] See Art. 33 of the ESAs founding regulation, as amended by the ESAs review (Regulation (EU) 2019/2175 of the European Parliament and of the Council of 18 December 2019).

[14] The Commission has repealed previously adopted equivalence decisions under the Credit Rating Agency Regulation in favour of Canada, Brazil, Singapore, Argentina and Australia. See Financial Times, "EU decisions on equivalence set to heighten UK post-Brexit fears" 28 July 2019, https://www.ft.com/content/a8f46a2c-b111-11e9-8cb2-799a3a8cf37b.

[15] See Financial Times, "EU-based traders caught in Swiss equivalence spat", 30 June 2019, https://www.ft.com/content/41091f2c-9ad0-11e9-9c06-a4640c9feebb.

[16] See the paragraph on financial services of the revised political declaration: https://ec.europa.eu/commission/sites/beta-political/files/revised_political_declaration.pdf.

unilateral assessments, not that they will recognise each other as equivalent. Henceforth, the EU will autonomously decide to what extent to adopt equivalence determinations, being also free to withdraw them without any need for the UK's consent. Naturally, the opposite will also hold true: after the transition period, the UK will have its own "equivalence regime", mirroring the one currently in force under EU law. The UK has in fact "on-shored" the entire body of EU financial legislation into its domestic regulatory framework, including the various EU equivalence provisions. After the transition period, UK legislation will give the UK Treasury the competence to adopt equivalence decisions with the technical support of the two UK regulators (the Financial Conduct Authority, FCA, and the Bank of England, BoE) in all the cases where the Commission can do so under EU law. Naturally, after the transition, the UK will also be able to modify its equivalence rules, extending the coverage or requirements according to which non-UK financial institutions can access UK financial markets. The risk is that, over time, the EU and the UK will develop not only diverging regulatory frameworks, but also divergent equivalence regimes, adding further layers of complexity to the already complicated EU-UK post-Brexit relationship.

So far, given the centrality of financial services in the UK economy, the UK has been mainly concerned with preserving cross-border market access with the EU and protecting the status of London as a global financial centre. Contrary to the EU, both the FCA and the BoE have established a temporary permissions regime, through which EU institutions servicing UK clients can continue to operate in the UK after the transition period on a temporary basis. This regime will give EU firms the necessary time (up to three years) to apply for an UK license to the UK competent authority, thereby avoiding market disruptions. However, the liberal approach of the UK to cross-border market access has a limited impact if it is not reciprocated by the EU. Henceforth, the UK government is seeking to conclude a binding agreement with the EU on equivalence access. The UK intends to insert binding equivalence commitments in the future free trade agreement (FTA) between the EU and the UK, whereby the two parties would take on the legal obligation to recognise each other as equivalent wherever possible under current EU rules. Alternatively, the UK would seek the commitment of the EU to preliminary consult the UK during the assessment, and before withdrawing an equivalence determination.[17] However, the EU has showed no interest in restraining its discretionary autonomy in the area of equivalence, as it intends to preserve the unilateral nature of the EU equivalence regime. The EU is willing to establish a non-binding, EU-UK regulatory forum whereby each party will be able to exchange information concerning their equivalence assessments, but without any enforceable obligation to grant market access to the other.[18]

So far, the EU has only adopted two temporary equivalence decisions, recognising as equivalent the UK regulatory framework for CCPs and central securities depositories (CSDs).[19] Those

[17] See Financial Times, "Sajid Javid to push for 'permanent equivalence' for City in Brexit talks", available here: https://www-ft-com.eur.idm.oclc.org/content/9623b8a2-4c3a-11ea-95a0-43d18ec715f5.
[18] See Financial Times, "Brexit: Barnier rebuts UK pitch for 'permanent equivalence' in financial services", available here: https://www.ft.com/content/34ab4fb8-4cbc-11ea-95a0-43d18ec715f5.
[19] See for example the decision on CCPs: Commission implementing decision (EU) 2019/2211 of 19 December 2019 determining, for a limited period of time, that the regulatory framework applicable to central counterparties

equivalence determinations were adopted by the EU out of necessity. The EU-27 banking sector is heavily reliant on UK CCPs to meet the clearing standards established under EMIR, whereas, until 2018, the Irish financial industry needed equivalence access to the UK-based CSD, since Ireland did not have any CSD under its jurisdiction. Given the current phase of political negotiations, the recognition of other UK market actors by the EU appears challenging due to the conflicting post-Brexit regulatory agendas pursued by the two parties. The UK government wishes to regain regulatory autonomy in the area of financial regulation, rather than continuing to apply EU regulatory and supervisory standards. Among UK regulators, there is a general awareness that financial regulation between the EU and the UK will eventually diverge after the transition period. The former governor of the Bank of England has recently stated that it would be inappropriate for the UK to become a "rule-taker", internalising EU rules without having any say on them.[20] Andrew Bailey, the incoming governor, has proposed a progressive overhaul of financial regulation after Brexit, abandoning the "rule-based" regulatory method characterising EU post-crisis financial regulation for a more flexible, "principle-based" approach.[21]

However, any major regulatory change to the UK system appears incompatible with the current position of the EU. In its negotiation guidelines, the European Council has stressed that cross-border services from the UK to the EU should occur under "host rules", which are the rules of the European Union.[22] The European Commission has also expressed its willingness to grant equivalence access to the UK only on the basis of close regulatory alignment to EU standards, to preserve the level playing field within the Single Market and protect EU financial stability.[23] Given the geographical proximity and financial interconnectedness between the UK and the Single Market, the EU considers the UK a "super-systemic jurisdiction" for equivalence purposes. Whereas the UK sees equivalence as an opportunity to preserve market liberalisation between two different (and increasingly divergent) regulatory systems, the EU is afraid to repeat the regulatory mistakes of the financial crisis, when mutual recognition without harmonisation between EU member states had proven conducive to a race to the bottom. Henceforth, the Commission is likely to demand strong regulatory alignment with EU standards in exchange of equivalence market access.

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in the United Kingdom of Great Britain and Northern Ireland is equivalent, in accordance with Regulation (EU) 648/2012 of the European Parliament and of the Council. https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019D2211&from=EN.

[20] Interview of Mark Carney at the Financial Times, "Central Banks running low on ways to fight recession, warns Mark Carney", https://www.ft.com/content/713a70b4-315d-11ea-a329-0bcf87a328f2.

[21] Speech of Andrew Bailey, former chief executive of the FCA and future President of the Bank of England, "The future of financial conduct regulation", https://www.fca.org.uk/news/speeches/future-financial-conduct-regulation.

[22] European Council guidelines for the Brexit negotiations, https://www.consilium.europa.eu/media/21763/29-euco-art50-guidelinesen.pdf.

[23] See the recent speech by Commission President von Der Leyen, "Old friends, new beginnings: building another future for the EU-UK relationship", where she said that "the more divergence there is, the more distant the partnership has to be". Answering a question from the public, she mentioned equivalence in the area of financial services as one of the areas where regulatory alignment is a *conditio sine qua non* to preserve cross-border market access. https://ec.europa.eu/commission/presscorner/detail/en/speech_20_3.

Overall, the divergent positions of the EU and the UK over cross-border market access appear, at present, difficult to reconcile. Either the UK agrees to follow EU rules after Brexit, or the EU will have to accept cross-border liberalisation without full regulatory alignment with EU standards.

EU/UK cross-border trade in financial services after Brexit.

Even as a third country, the UK and in particular the City of London will continue to play a pivotal role for the European financial industry. The EU financial ecosystem is currently dependent on wholesale services originating from UK financial markets, infrastructures and firms.[24] This is especially the case for derivatives clearing, with UK clearing houses processing almost 90% of all OTC derivatives contracts concluded by euro area financial institutions. However, the financial dependency of the EU on London goes beyond the derivatives and clearing sector. The UK provides a 'single-stop' marketplace relied upon by EU corporations to obtain a plurality of wholesale financial services, ranging from syndicated loans to fintech applications. It is also the preferential European hub for American, Japanese and other third country financial groups, which have established the base of their EU operations in London. The UK financial sector has a positive trade balance, which is more than ten times greater than the one of France, Germany, and Ireland. Tax revenues from the financial sector in UK are one hundred times greater than Germany (Batsaikhan *et al*., 2017).

Given the importance of the UK financial industry for the EU, a critical question is under what regulatory regime those systemic financial institutions will provide services in the Single Market after Brexit, and what could be the consequences of the loss of passporting rights of the UK financial industry for EU regulation and supervision. After the transition period, when the UK will become a full-fledged third country and it will lose access to the Single Market, UK financial institutions will have three possibilities to continue their EU operations.

Firstly, they can relocate in an EU member state. Secondly, they can rely on the EU equivalence regime, provided that it is available under EU law and the Commission has positively recognised UK regulation as equivalent. Thirdly, they can provide services in specific EU jurisdictions according to (bilateral) national third country regimes. Each of those regulatory avenues will have a different impact on the capacity of the EU to protect financial stability within the Single Market, as each of those alternatives to passporting occurs under a different regime in terms of regulation and supervision. It is thus worthy to briefly analyse them in turn.

Relocation of financial activities from the UK to the EU.

Financial institutions currently located in the UK can continue to provide services to EU clients by relocating in an EU/EEA member state. Relocation implies the establishment of a fully capitalised subsidiary, legally incorporated in an EU/EEA member state, which is independent from other affiliates of the same financial group in terms of staff, risk-management and capital and liquidity requirements. Relocation has been proactively encouraged by the Commission,

[24] See the speech by Luis de Guindos, Vice President of the ECB, "Europe's role in the global financial system", https://www.ecb.europa.eu/press/key/date/2020/html/ecb.sp200108~323f3e7dac.en.html.

the ESAs and the European Central Bank (ECB), as they have all issued Brexit opinions to warn the UK financial industry of the disruptive effects of a potential hard Brexit on their capacity to serve the Single Market without a subsidiary.[25]

This strategy seems, at least in part, to be working. Brexit is leading to the migration of certain financial activities from London to various financial centres located in the EU-27. Many UK financial institutions have relocated in the EU, whereas financial groups that already had subsidiaries on one or more EU/EEA member states are moving their financial operations to those EU-based entities. Relocation constitutes a favourable outcome for the EU. Since subsidiaries must follow the regulation and supervision of the jurisdiction where they are located, the services provided within the EU by the relocated entities will continue to be based on EU law. Those EU-based institutions will continue to benefit from passporting rights, retaining the ability to service EU clients and operate in the Single Market. They will also need to be fully compliant with EU law, meaning that the EU will continue to regulate and supervise them. Moreover, in case of market distress, the ECB will be able to act as lender of last resort and, when available, those relocated subsidiaries will be subject to the EU resolution regime.[26]

However, relocation is not without risks from a stability perspective. The problem is how to ensure that UK financial firms effectively relocate in the Single Market, and do not create 'letter-box' entities with the sole scope of retaining EU-wide market access after Brexit. The ESAs have adopted Brexit opinions to show their supervisory expectations in the relocation procedures. UK financial institutions will need to demonstrate to the relevant EU regulators that sufficient staff and risk management is available in the new entity, and that every outsourcing and delegation arrangement back to the UK is accountable for and does not turn the EU subsidiary into an 'empty shell' (Hanten and Sacarcelik, 2018). However, whereas the ECB is exclusively responsible for granting new licenses to relocating credit institutions within the Single Supervisory Mechanism (SSM) framework, the relocation of non-banking entities is overseen at the national level by national competent authorities. Although the ESAs are actively promoting supervisory convergence in the relocation procedures, they have limited capacity to control domestic supervisors. In the context of the reform of the ESAs founding regulation, the Commission had proposed to strengthen the capacity of the ESAs to monitor delegation and outsourcing arrangements between the UK and the EU, but the proposal did not survive the political negotiations between the European Parliament and the Council. The concrete risk is

[25] In the Brexit preparedness notices adopted by the European Commission to help the financial industry prepare for Brexit, market actors are encouraged to prepare for Brexit without relying on equivalence access. In a similar vein, EU supervisors (ESMA, EIOPA and EBA) have also released 'Brexit' opinions, requiring UK market actors servicing EU clients to relocate to continue their EU operations, and highlighting their expectations in terms of relocation after Brexit. See for example the EBA opinion here: https://eba.europa.eu/sites/default/documents/files/documents/10180/1756362/81e612c6-dcab-4c4b-87e9-32784cb44de1/EBA%20Opinion%20on%20Brexit%20Issues%20%28EBA-Op-2017-12%29.pdf?retry=1.

[26] Although EU law only provides a resolution framework for credit institutions, there is increasing awareness within EU Institutions of the risks originating from the disorderly default of systemic non-banking entities. For example, a proposal for the orderly resolution of EU CCPs is under discussion at the EU level.

to have EU member states competing with each other to become the destination of choice for the relocation procedures of the UK financial industry. This form of regulatory competition may lead national authorities to apply sub-optimal supervisory standards to the EU subsidiaries of UK non-banking financial institutions.

The EU equivalence regime and national third country regimes.

Despite the on-going migration of parts of the UK financial industry to various EU financial centres, the post-Brexit financial relationship between the EU-27 and the UK will still be characterised by a substantial level of cross-border financial activities. Not every UK-based financial institution currently servicing EU clients can relocate to the Single Market. For certain activities, such as clearing services conducted by Central Counterparties, relocation is difficult because of network effects and the need to preserve economies of scale. For others, establishing a fully-capitalised subsidiary both in the EU and the UK to operate in both jurisdictions may not be economically or factually viable.[27] The financial activities between the UK and the EU that will continue to be cross-border (i.e. originating from an UK institution and directed at EU counterparties or clients) will be regulated by two different legal frameworks. Firstly, UK financial firms will be able to provide services to EU clients through the EU equivalence regime. Equivalence constitutes the best solution for the UK financial industry and the UK, since it empowers UK institutions to operate in the entire Single Market without the costly need of establishing an EU subsidiary. However, as we have seen, equivalence is not always available, and it is dependent on a positive determination by the Commission. When those two conditions do not apply, UK financial institutions can still provide cross-border financial services in specific EU jurisdictions through national third country regimes. National legislation only allows access to national markets, and UK financial institutions must be compliant with the requirements established under national law.

From the perspective of the EU, equivalence-based access presents both benefits and shortcomings. The main shortcoming is that it preserves the status quo between the EU and the UK. If the UK financial sector can still rely on equivalence to access the Single Market, it has no incentive to relocate in EU/EEA member states. This could accordingly preserve the state of financial dependency of the EU on the UK, and the need of EU regulators to rely on UK authorities to protect EU financial stability.[28] Under equivalence, in fact, the EU would delegate the day-to-day regulation and supervision of cross-border financial entities to UK authorities. Moreover, in a crisis, the liquidity support and resolution of those entities would fall under the

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[27] This may be the case of the fund industry, currently regulated under EU law by the UCITS and Alternative Investment Funds Managers (AIFM) directives, which extensively relies on outsourcing and delegation to operate across jurisdictions. Delegation and outsourcing can be considered, to a certain extent, very similar to equivalence access, as those mechanisms will allow managers located in the UK to manage funds located in the EU, even after the UK will become a full-fledged third country. For this reason, the EU is thinking of restraining or making more burdensome the delegation and outsourcing rules under UCITS and AIFM directives. See Financial Times, "How the EU will reshape fund managers regulation after Brexit?", https://www.ft.com/content/1f034e4a-4e33-4ba9-bcfc-dedb44ed6703.

[28] For example, the EU was forced to temporarily recognise UK CCPs and trade repositories, as the EU financial industry was dependent upon the services provided by those UK infrastructures.

purview of the Bank of England, which would have little incentive to take into consideration potential fiscal and monetary spill-over effects on the EU.[29] Although ESMA would have certain supervisory powers over UK investment firms, CCPs, Credit Rating Agencies and hedge funds, equivalence would still put UK authorities in the driving seat when it comes to the regulation, supervision and resolution of financial institutions that, although located in the UK, would have a systemic impact also on EU financial stability.

However, equivalence also presents substantial advantages for the EU. Firstly, equivalence constitutes a regulatory mechanism through which the EU can continue to influence UK financial regulation and supervision. Under equivalence, the Commission negotiates on behalf of the entire EU (and EEA) the regulatory and supervisory conditions to liberalise trade in financial services with third countries. Through equivalence, the EU as a whole can obtain more favourable trade conditions from the UK than every EU member states would on a stand-alone basis.

Secondly, equivalence could provide a single and controlled point of access to the EU for UK financial providers, with great advantages in terms of market liberalisation but also financial stability protection. Under equivalence, the Commission and ESMA act as 'gatekeepers', ensuring that third country financial institutions do not endanger EU financial stability. When equivalence is not available or it is not used, EU member states can implement their own, domestic or bilateral 'third country' regimes through national legislation. This is already the case: several EU member states have adopted Brexit-related, emergency legislation to facilitate the access of UK capital markets institutions to their national jurisdictions after Brexit.[30] They give national competent authorities the power to temporarily authorise UK financial institutions (especially the ones providing investment management, derivatives and insurance services) to continue their operations in the relevant EU jurisdiction. Those national 'Brexit bills' have been unilaterally adopted by national governments, without any coordination at the EU level. Although their validity is limited in time, and they only apply within local jurisdictions, they can be unilaterally renewed by each EU member state after the transition period. At some point the ESAs are supposed to intervene, checking to what extent those legislative initiatives are needed and, most of all, are compliant with EU law. But it would take time, and it is to be seen to what extent the ESAs and the Commission will want to spend political capital to rein in those national initiatives. Without equivalence, the risk is of having a post-Brexit regulatory landscape characterised by 27 different national regimes, unilaterally managed by national competent authorities, and relied upon by UK financial actors to provide services in the EU. From a financial stability prospective, this is a worrisome situation, with the level playing field

[29] The financial crisis has shown that, in a cross-border context, home regulators tend to ignore negative externalities and spill-over effects on host jurisdictions – on great peril to financial stability (D'Hulster, 2011).

[30] Several EU member states, including Germany, the Netherlands, France, Italy and Sweden, have adopted emergency legislation to allow the UK financial industry to continue servicing their national markets even after Brexit, although for a limited period of time. See Bloomberg, "British Banks are getting a last-minute break from the EU", https://www.bloomberg.com/news/articles/2019-02-20/brexit-fears-drive-eu-nations-to-seek-reprieve-for-london-banks.

within the Single Market completely disrupted by 27 different regulatory regimes, managed by as many national competent authorities.

The supervision of third country economic actors under equivalence.

Since equivalence is bound to play an important role in the EU-UK post-Brexit relationship, it is important to understand how third country financial institutions are supervised under this mechanism. In principle, equivalence is an instrument of deference, meaning that third country economic actors accessing the Single Market under equivalence are supervised by their home authorities. Deferring the oversight of those entities to third countries, the EU can avoid certain extraterritorial effects of EU financial rules and promote supervisory cooperation at the international level, thus fostering the globalised and integrated nature of financial markets.

However, equivalence-based access can, as a result, also endanger EU financial stability. Although financial providers are economic actors with systemic properties, the EU chiefly relies on foreign jurisdictions for their daily supervision. The EU equivalence regime presents two shortcomings from a supervisory perspective. Firstly, it is incoherent from an institutional perspective. In certain cases, third country institutions must apply for registration or recognition to the ESAs, in others to national competent authorities (Deslandes *et al*., 2019). The fact that multiple institutions are involved in the equivalence process hinders the capacity of the EU to have a comprehensive supervisory overview of third country financial activities and financial stability risks in the Single Market. Secondly, outside circumscribed (but increasing) cases, the ESAs and the ECB normally lack strong enforcement powers to properly oversee the EU activities of third country institutions. If for example third country authorities fail to exchange information with the EU on third country financial institutions, EU supervisory authorities have often little powers to address the situation.[31]

ESMA, in particular, has been concerned with the financial stability risks potentially originating from foreign market actors operating in the Single Market under equivalence.[32] The liberal stance of the EU – relying on other regulators for the management of cross-border risks – is in stark contrast with the approach adopted by other major jurisdictions. In the US, for example, regulators do not delegate the oversight of systemic risks to other regulators, but they require foreign entities servicing US clients to be registered and supervised by the US authorities.

Those supervisory shortcomings are particularly worrisome when equivalence allows financial institutions with systemic properties to operate in the EU and service EU clients. This was for example the case for third-country Central Counterparties, which after the crisis have become "super-systemic" institutions, with the responsibility to process a staggering amount of OTC derivatives contracts. Under the original EU equivalence regime (EMIR), the EU had to chiefly rely on foreign regulators for the supervision of foreign CCPs providing clearing services to EU

[31] ESMA, for example, laments the lack of powers to properly mitigate potential systemic risks originating from third country CCPs (ESMA, 2015).

[32] See remarks of ESMA chair Steven Maijoor in "Review of the European Supervisory Authorities: Opportunities to ensure a safe and sound financial system", https://www.esma.europa.eu/sites/default/files/library/esma71-844457584-346_review_of_the_european_supervisory_authorities_-_steven_maijoor.pdf.

clients, even when those CCPs could have a systemic impact on the stability and resilience of the Single Market. Once a jurisdiction was deemed by the Commission as equivalent, ESMA could not differentiate between systemic and non-systemic market players, and it had limited powers to identify and prevent systemic risks. A similar problem was also identified in the equivalence regime for investment firms under MiFID II/MIFIR. Although this equivalence regime has yet to be used, the supervisory powers granted to ESMA were considered insufficient to properly address potential financial stability and level playing field risks.

To address this issue, the EU has recently reinforced the supervisory framework for third country CCPs (EMIR 2.2) and Investment Firms (the Investment Firm Review, IFR), increasing the oversight powers of ESMA and the ECB under equivalence. Both reforms seek to strengthen the capacity of EU authorities to oversee third country systemic institutions, namely those market actors whose distress could endanger EU financial stability. Under EMIR 2.2, foreign CCPs are classified in two groups according to their systemic relevance for EU financial stability. Non-systemic third country CCPs (Tier 1) will continue to be exclusively supervised by their home country regulator. The most systemic market players (Tier 2), however, will be subjected to certain EU regulatory standards and the direct supervision of ESMA, a last-resort power of the EU can also lead to the imposition of a relocation requirement for the most systemic CCPs. Since after the crisis CCPs have become fundamental channels to transmit monetary decisions, and their distress would require liquidity support with central bank money, the ECB will also be involved in the oversight of Tier 2 CCPs. The ECB will be able to impose specific requirements to Tier 2 CCPs; it will participate to third country CCP supervisory colleges; and it will also contribute to the CCP Supervisory Committee, an ESMA special Committee responsible to ensure supervisory convergence between EU and third country CCPs.[33]

Following a similar pattern, the new Investment Firm Review (IFR) will also see the division of EU investment firms into various categories according to their systemic relevance for EU financial stability. Investment firms considered systemic will be assimilated for regulatory and supervisory purposes to "credit institutions" under the CRD IV legislation.[34] This means that these systemic investment firms will no longer be supervised by national competent authorities, but they will fall under the oversight of the ECB in the context of the Single Supervisory Mechanism. Although this reform only applies to investment firms established in the EU, it will be applicable to the largest UK investment firms relocating to the Single Market after Brexit.[35] However, the IFR does not only cover investment firms established in the EU, but

[33] See Regulation (EU) 2019/2099 of the European Parliament and of the Council of 23 October 2019 amending Regulation (EU) No 648/2012 as regards the procedures and authorities involved for the authorisation of CCPs and requirements for the recognition of third-country CCPs. https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019R2099&from=EN.

[34] Investment firms will fall under the notion of "credit institution" under the CRD IV legislation when their consolidated assets exceed €30 billion.

[35] See the European Commission Proposal for a Directive on the prudential supervision of investment firms, according to which systemic financial investment firms are "largely concentrated in the UK but are in the process of considering plans to relocate parts of their operations to the EU-27, notably to member states participating in the Banking Union". https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52017PC0791&from=en.

also those located in third countries. The equivalence regime for non-EU investment firms follows the same structure as the previous one: investment firms located in a third country recognised as equivalent by the Commission will be able to provide investment services to professional and eligible (but not retail) EU clients. However, the supervisory framework for those foreign market actors has been reinforced, this time to the benefit of ESMA, which will obtain *quasi*-supervisory powers over foreign investment firms. ESMA will be able to request information from third country authorities and investment firms, carry out supervisory activities like on-site inspections and prohibit certain activities when they could endanger EU clients.

These legislative reforms substantially strengthen the supervisory framework for certain regulated activities (central clearing and investment services) falling under the equivalence regime. However, they also increase the degree of institutional complexity in the supervision of third country institutions, since oversight powers are once again scattered between national competent authorities, ESMA and the ECB. For example, investment firms providing services in the Single Market are subjected to a spaghetti bowl of supervisors: non-systemic EU investment firms will be supervised by national authorities, systemic ones by the ECB, while third country entities will fall under the jurisdictional remit of ESMA. In a similar vein, the supervision of CCPs also raises concerns from an institutional perspective: Tier 2 third country CCPs will be simultaneously overseen by ESMA and the ECB in addition to their home authorities, with different but often overlapping powers. The two institutions will need to closely cooperate in the implementation of EMIR 2.2, to avoid inconsistencies and supervisory gaps.

Overall, these two reforms follow a 'piece-meal' approach, leaving untouched the supervisory shortcomings in other third country regimes. ESMA, for example, has proposed to apply the tiering approach of EMIR 2.2 to all third country market infrastructures covered by equivalence.[36] However, neither the European Commission nor member states seem ready to pay the political costs of carrying out a wide-ranging reform of the equivalence framework, to enhance institutional coherence and simplify the current patchwork of divergent regulatory regimes.

Conclusion: the need for a more coherent EU equivalence regime.

Equivalence has a long history within EU financial legislation, well before and beyond Brexit. However, the departure of the UK has unexpectedly turned equivalence into a fundamental mechanism in EU financial regulation and supervision. Legally engineered to facilitate cross-border market access with smaller (Switzerland) or distant (USA) financial partners, it is suddenly being called on to mend the broken financial relationship between the EU and a former EU member state, moreover one that hosts the most developed financial centre

[36] See "ESMA response to the public consultation on the operations of the European Supervisory Authorities", https://www.esma.europa.eu/sites/default/files/library/esma03-173-194_letter_to_the_commission_vice_president_-_formal_response_to_consultation_on_the_review_of_the_operation_of_the_esas.pdf.

worldwide, not even an hour away from the rest of the EU.[37] Rather than representing *the* solution to the Brexit conundrum, the equivalence regime will constitute one among many regulatory instruments available to the EU to manage UK/EU cross-border trade after Brexit. Alongside the EU equivalence regime, the UK financial sector can continue to service EU/EEA clients through relocation in the EU and the related application of EU passport, or alternatively at the cross-border level under national regimes. Equivalence could, however, represent the best mechanism in the EU regulatory toolbox to preserve the level playing field within the Single Market as it establishes a single point of access to the EU for the entire UK financial sector.

The EU has recently adopted important reforms to EU financial legislation (EMIR 2.2, IFR and the review of the ESAs founding regulations) in order to strengthen the capacity of equivalence to support EU financial stability and serve as a level playing field mechanism after Brexit. ESMA is clearly the institutional actor to benefit the most from these legislative reviews. It acquired the power to monitor equivalent third country, as well as the responsibility to supervise systemic third country actors such as Central Counterparties and Investment Firms. The good news is that, since those extensive oversight powers are only applicable to third country entities, ESMA is increasingly becoming an external supervisor with gatekeeping functions in the context of equivalence. The bad news is that, from a financial stability perspective, those recent legislative reforms are not sufficient. Given its fragmented and patchy nature, equivalence is still miles away from achieving its potential, namely granting EU institutions an instrument to ensure a level playing field within the Single Market and supervisory control over foreign economic actors operating in the EU. For this, a much more comprehensive and holistic reform of the equivalence regime is necessary, affecting not only certain regulated activities, such as central clearing and investment services, but the entire corpus of financial entities falling under the scope of equivalence.

It is time for the EU to abandon the 'salami-slice' approach to equivalence, with many different regimes, each establishing different regulatory and supervisory conditions. Although the current EU equivalence regime has allowed the EU to tailor equivalence-based access to the specificities of each regulated activity, it is no longer fit for the purpose for which it was established: achieving a good balance between (global) financial integration and (domestic) financial stability. On one hand, the lack of coherence in the procedures and requirements to access EU capital markets hinders the international competitiveness of the EU. This runs against the long-term commitment of the EU to establish a capital market union. On the other hand, the absence of a centralised regulatory and supervisory point of access partially leaves the EU without jurisdictional control over systemic risks originating from third countries, especially when, after the transition period, the extent of financial services regulated under equivalence and national third country regimes will increase exponentially.

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[37] Geographical proximity constitutes a fundamental determinant of the level of cross-border trade in financial services between two jurisdictions. See the speech of Klaas Knot, "Interests and alliances", available here: https://www.dnb.nl/binaries/200108%20publicatieversie%20%202%20opening%20speech%20klaas%20knot%20suerf%20conference_tcm46-386832.pdf.

The EU should establish a single supervisory procedure for all the regulated activities currently covered by equivalence. Presently, the recognition of a third country' regulatory regime is centralised in the hands of the Commission, whereas the supervision of third country financial institutions is divided between EU supervisory authorities and national supervisors, in a spaghetti of competences which can lead to financial stability risks. Whereas the Commission should continue to adopt equivalence determinations, third country financial institutions should always have to apply for registration or authorisation to a competent EU supervisory authority, which would then become exclusively responsible for their supervision within the EU.

Following the EMIR 2.2 template, the EU would not need to directly supervise every third country financial institution operating in the Single Market, but only those of systemic relevance, with the capacity to disrupt the level playing field and endanger EU financial stability. The supervision of those entities could fall under ESMA, or the ECB, or a smart combination of both. Reforming the EU equivalence regime should be possible through the adoption of a single regulation, reviewing all the equivalence rules scattered across the EU single rulebook.

Unfortunately, so far, any wide-ranging reform of the EU equivalence regime has been prevented by the political differences of EU member states concerning the post-Brexit future of the Single Market for financial services. The lack of political coherence between national governments has allowed only a piecemeal approach to equivalence-related reforms. In the long term, this is a mistake, as a more streamlined approach to equivalence would strengthen the regulatory influence of the EU at the international level, facilitate cross-border market access and maximise jurisdictional control over systemic third country firms.

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