BRIEFING

European Parliament

Third country equivalence in EU banking and financial regulation

Drawing on the EGOV briefing "Third-country equivalence in EU banking legislation" updated in July 2017, this briefing provides an insight into the latest regulatory developments on equivalence, including elements of the on-going ESA review, the Investment Firm Review, and EMIR 2.2 that are being discussed at Parliament and Council. The focus of this briefing is on the supervisory and regulatory regime for banking and financial services provided on a cross-border basis by third country firms in the EU under equivalence regimes. The briefing also gives an overview on the possible role of equivalence regimes in the context of Brexit.

1. Today's 'equivalence' regimes

Rationale and objectives

The EGOV briefing "Third-country equivalence in EU banking legislation" analysed in detail the key differences between:

- 'passporting' rights for firms established in a Member State or in an EEA country (enshrined in secondary legislation), and
- 'equivalence' regimes for third countries (provided for in financial services legislation) that may be discretionarily activated or revoked by the Commission.

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

Equivalence is primarily used to recognise third country regime for prudential purposes and reduce overlaps in terms of regulatory and supervisory compliance in the interest of EU financial institution or market participants. By way of example, in banking, under the Capital Requirements Directive (CRD), credit institutions may, for the calculation of capital requirements, prudentially treat certain third-country exposures the same way as EU exposures, subject to an equivalence decision.

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In a limited number of cases, equivalence - subject to conditions and processes laid down in the relevant sector legislation - may also provide third country firms with access to the internal market. This briefing focuses on this cross-border provision of services by third country firms further to an equivalence decision.

A Commission Staff Working Paper ("EU equivalence decisions in financial services policy: an assessment") from February 2017 assigned two general objectives to equivalence decisions: i) balancing the need of financial stability and investor protection in the EU with the benefits of maintaining open and globally integrated EU financial markets; ii) promoting regulatory convergence around international standards and upgrading supervisory cooperation.

Commission's discretion

Equivalence decisions are a unilateral decision by the Commission. The Commission "ultimately exercises its discretion as conferred upon it by the "empowerment" given in EU sectoral legislation, taking into account objectives stemming from the empowering legislation and the Treaty, as emphasised in the Commission staff working paper mentioned above. That working paper stresses that those objectives, including promoting the internal market, financial stability and market integrity, are "*considered in view of the factual and legal circumstances of each case*".

Box 1 - Example of equivalence decision for Swiss stock exchanges

In its decision to recognise the legal and supervisory framework for Swiss stock exchanges to be equivalent, the Commission motivated a one year time-limited equivalence on "institutional" grounds: "*This Decision also takes into account the Council conclusions of 28 February 2017 in accordance with which a precondition for further developing the sectoral approach with Switzerland is the establishment of a common institutional framework [...] When deciding on whether to extend the applicability of this decision, the Commission should in particular consider progress made towards the signature of an Agreement establishing that common institutional framework*".

Different regulatory approaches

EU equivalence provisions governing the access to the single market on a cross-border basis have been included in EU financial legislation over the years in order to cover certain specific financial services. The conditions to be fulfilled may vary depending on the nature of service provider, the service itself, and the potential customers of the service.

In accordance with the *acquis communautaire* of the EU, most core banking and financial activities are not subject to an equivalence regime providing access to the single market. This includes:

- Deposit-taking in accordance with the Capital Requirements Directive ;
- Lending in accordance with the Capital Requirements Directive ;
- Payment Services in accordance with the Payment Services Directive; and
- Investment services to retail clients.

Those core banking activities mostly involve retail clients, which are subject to depositor protection in the EU and stricter investor protection rules. Absent an equivalence regime, for most core banking activities third country firms need to establish a legal entity (i.e. a subsidiary in the EU) to provide those services across the Union. Nevertheless, individual Member States may still provide access to third country providers, but only to their home market (see model 3 below for further information).

In that respect, the February 2017 Commission's staff working paper stressed that "*equivalence decisions in a few areas may enhance the possibilities of doing business in the EU (e.g. investment firms*

under MiFID II), but the equivalence as such serves primarily prudential regulatory purposes and is a tool to reduce overlaps in compliance in the interest of EU markets".

Access to the internal market is possible today under equivalence regimes for the following key banking and financial activities related to firm's wholesale business, subject to conditions laid down in sector legislation:

- Alternative investment funds under AIFMD[1] for professional investors;
- Clearing under EMIR[2]; this equivalence regime is being reviewed in a Commission's proposal adopted in June 2017[3] (hereinafter "EMIR 2.2") that is being discussed at the Parliament and Council (See section 2 below);
- Investment services for professional clients and eligible counterparts under MiFIR[4]; this equivalence regime is being reviewed as part of the Investment Firm Review[5] that is being discussed at the Parliament and Council. MiFIR equivalence regime applies to both credit institutions providing investment services and investment firms.

EU banking and financial legislation takes a "sectoral" approach (depending on whether the service is capital market driven or not) as opposed to an "activity-based" approach. The very same activity of providing a guarantee or a loan to a professional client could be subject to equivalence decision when falling within the scope of "investment services[6]" under MiFID/MiFIR (capital market) for both credit institutions and investment firms, while a guarantee or a loan directly provided by a credit institution (banking intermediation) does not benefit from an equivalence regime under CRD.

Financial services legislation also include other equivalence regimes for securities markets that are not dealt with in this briefing (See EGOV briefing "Third-country equivalence in EU banking legislation" for a comprehensive description of the different equivalence regimes).

Until today equivalence regimes have not been activated for alternative investment funds nor for investment services for professional clients (MiFIR only applies from 3 January 2018). Should the Commission at some point activate equivalence regimes, firms established in a third country offering alternative investment funds or investment services to professional clients will have access to the internal market without establishing a legal entity or a branch in the Union. For alternative investment funds under AIFMD, third country firms will nevertheless be required to have a "legal representative" in the Union.

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[1] Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers, OJ L 174, 1.7.2011, p. 1.

[2] 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, OJ L 201, 27.7.2012, p. 1.

[3] Commission proposal (COM (2017) 331) for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 1095/2010 establishing a European Supervisory Authority (European Securities and Markets Authority) and 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.

[4] Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments, OJ L 173, 12.6.2014, p. 84.

[5] Commission proposal (COM (2017) 790) for a Regulation of the European Parliament and of the Council on the prudential requirements of investment firms and amending Regulations (EU) No 575/2013, (EU) No 600/2014 and (EU) No 1093/2010 and Commission proposal (COM (2017) 791) for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on the prudential supervision of investment firms and amending Directives 2013/36/EU and 2014/65/EU

[6] Investment services under MiFID include "Underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis" and "Granting credits or loans to an investor to allow him to carry out a transaction in one or more financial instruments, where the firm granting the credit or loan is involved in the transaction".

In terms of supervision of third country entities, financial services legislation provides for different models that are stylised below:

Model 1: For asset management, under AIFMD, access to the single market is contingent upon two regulatory checks, providing a "double-lock" system: i) equivalence assessment and decision by Commission and ii) authorisation by the national competent authority of the "Member State of reference", which is designated according to criteria laid down in AIMD. In addition, the AIFMD provides further supervisory requirements:

- Under the AIFMD third country passport regime, a non-EU AIFMD shall comply with most substantive rules of the Directive unless it can demonstrate that this is impossible or the third country law provides for an equivalent rule;
- The AIFM needs to appoint a legal representative established in the Member State of reference that performs the compliance function pursuant to AIFMD;
- Cooperation arrangements shall be in place between the third country and the Member State of reference "*in order to ensure at least an efficient exchange of information that allows the competent authorities to carry out their duties in accordance with this Directive*".

Model 2: For investment services to professional clients, under MiFIR, third country firms need to be "registered" and shall provide the European Securities and Markets Authority (ESMA) with specific information, but this "registration" does not extend to an additional "authorisation". ESMA has to keep the register up-to-date. Nevertheless, ESMA has the power to withdraw the registration of a third country firm on the ground of "*well-founded reasons*" spelled out in MiFIR and based on documented evidence. Third countries investment firms shall inform clients established in the Union before the provision of any investment services that they are not allowed to provide services to retail clients and that they are not subject to supervision in the Union. Cooperation arrangements shall also be in place.

Model 3: For other core banking activities (deposit-taking, payment and lending), the Capital Requirements Directive (CRD) and the Payment Services Directive (PSD) do not provide for equivalence mechanisms. Absent an equivalence mechanism, conditions to access national market are left to national law and national implementation. Banks may be required to set up a third country branch that will only be authorised to provide service in the Member State in which it is established.

Model 3 is also applicable in other financial services legislation in lieu of equivalence. Under AIFMD, Member States may allow alternative investment funds managers who are not established and authorised in the EU to market AIFs (EU AIFs and non-EU AIFs) only in their territory under the so-called National Private Placement regimes ("NPPR"). The third country regime under MiFID II/MiFIR offers Member States the possibility to allow third country firms to provide investment services in their territories in accordance with national regimes (both for retail and professional clients). Those investment services cannot be 'passported' inside the EU.

A **4th model** is being discussed at the Parliament and Council further to the proposal by the Commission to amend EMIR (See Part 2).

Against the background of the different regulatory approaches outlined above, the Commission has stressed in its staff working paper that "equivalence provisions are tailored to the need of each specific act".

Supervisory cooperation and enforcement mechanisms

Under the EU 'passporting regime' (i.e. access to the whole internal market), enforcement of supervisory decisions is subject to supervisory cooperation between home and host authorities in the EU. By way of example, the CRD provides for a supervisory arrangement under Article 41 to ensure that actions are effectively taken by the home competent authorities[7].

The equivalence regimes for third country firms may also provide access to the single market (i.e. as the "passport regime" does), but with a less clear delineation and articulation of supervisory responsibilities between "home" (i.e. third country authorities) and host authorities (EU authorities) and without a legally-binding mediation mechanism. Supervisory co-operation and enforcement relies on a non-legally binding memorandum of understandings referred to as "cooperation arrangements".

In MiFIR, those cooperation arrangements are a condition for ESMA to recognise third countries firms and shall govern the procedures concerning the coordination of supervisory activities and exchange of information (see box 2 in relation to MiFIR).

Box 2 - Cooperation arrangements under MiFIR Article 47(2)

"ESMA shall establish cooperation arrangements with the relevant competent authorities of third countries whose legal and supervisory frameworks have been recognised as effectively equivalent in accordance with paragraph 1. Such arrangements shall specify at least:

(a) The mechanism for the exchange of information between ESMA and the competent authorities of third countries concerned, including access to all information regarding the non-Union firms authorised in third countries that is requested by ESMA;

(b) The mechanism for prompt notification to ESMA where a third-country competent authority deems that a third- country firm that it is supervising and ESMA has registered in the register provided for in Article 48 infringes the conditions of its authorisation or other law to which it is obliged to adhere;

(c) The procedures concerning the coordination of supervisory activities including, where appropriate, on-site inspections"

EMIR also provides for cooperation arrangements between ESMA and the relevant non-EU authorities whose legal and supervisory framework for CCPs have been deemed equivalent to EMIR by the European Commission. In that respect, ESMA and the US Commodity Futures Trading Commission (CFTC) have established a Memorandum of Understanding (MoU) under EMIR.

Under AIFMD, in addition to cooperation arrangements, enforcement is facilitated by the appointment by the third country alternative investment fund manager of a legal representative established in the Member State of reference. This legal representative is the "contact person" for ESMA and the national competent authorities and shall perform the compliance function pursuant to the AIFMD.

2. Proposed changes to existing 'equivalence' regimes

The Commission has recently proposed regulatory changes to enhance some EU equivalence regimes: in September 2017 as part of the ESA review, in December 2017 as part of the Investment

[7] The home competent authorities are required under Article 41 to take all appropriate measures to ensure that the credit institution concerned remedies its non-compliance or takes measures to avert risk of non-compliance. Disagreements between home and host authorities are dealt with under EBA Article 19 Regulation dispute settlement mechanisms.

Firm review, and in June 2017 in relation to a review of EMIR. Those changes are summarised in Box 3 below. Those proposals are being discussed at Parliament and Council.

The ECON Committee has tabled an own-initiative report on relationships between the EU and third countries concerning financial services regulation and supervision (see draft report dated 4 April 2018, Rapporteur Brian Hayes).

Ex-post and on-going monitoring

As part of the on-going review of the European Supervisory Authorities (ESAs), the Commission has proposed an enhanced *ex post* monitoring of equivalence decisions involving the relevant European Supervisory Authorities (ESMA, EBA - the European Banking Authority, and EIOPA - the European Insurance and Occupational Pensions Authority). Importantly, this *ex post* monitoring is not limited to regulatory issues but also extends to supervision and enforcement.

The Commission has proposed to amend Article 33 of the ESAs founding Regulations as follows:

- ESAs are tasked with the monitoring of regulatory and supervisory developments and relevant market developments in third countries for which equivalence decisions have been adopted by Commission;
- ESAs are asked to submit a confidential report on its findings to the Commission on an annual basis, with a particular focus on financial stability, market integrity, investor protection or the functioning of the internal market;
- ESAs are requested to cooperate with third countries national authorities on the basis of administrative arrangements that should allow the ESAs to obtain relevant information for the purposes of monitoring the equivalence decision. In the same vein, the investment firm review and EMIR 2.2 have introduced on-going monitoring mechanism for equivalence decisions.

The matters dealt with in the reports of ESAs to the Commission are of confidential nature. In that respect, however, it must be noted that the Commission has not proposed as part of the ESA review any further scrutiny mechanism for the European Parliament and the Council. Equivalence decisions remain mainly implementing decisions by the Commission (e.g. EMIR, MiFIR) as opposed to delegated acts (e.g. in AIFMD).

Strengthened mechanisms to supervise third countries firms

In terms of supervision, the recent Commission's proposals (EMIR 2.2 and the Investment Firm review) suggest improving supervision in the following ways.

*A new supervisory approach under EMIR 2.2 ("**Model 4**")*

EMIR 2.2 (as proposed by the Commission in June 2017) would entrust ESMA with the supervision of third country CCP which are subject to proportionate requirements depending on whether ESMA determines a CCP to be systemically important or likely to become that (Tier 2 CCP). Tier 2 CCP are subject to the following requirements that come down to a "dual supervision" from both ESMA and the third country competent authorities. As explained in the accompanying Commission's impact assessment, ESMA would have full access to information and the same powers as for CCPs established in the EU.

Requirements include:

- Tier 2 CCPs willing to service clearing members or trading venues established in the EU would be authorised by, and registered with, ESMA following an authorisation process comparable to that of CCPs established in the EU;

- Compliance with material rules of EMIR (Article 16 and Titles IV and V of EMIR). ESMA has to take into account the extent to which an CCP's compliance with those requirements is satisfied by the CCP's compliance with the comparable requirements applicable in the third country (‘*comparable compliance*’);
- The CCP shall provide ESMA with its unconditional written consent, signed by the legal representative of the CCP, to provide within 72 hours after service of a request by ESMA any documents, records, information and data held by such CCP at any time, and that ESMA may access any of the CCP’s business premises, as well as a reasoned legal opinion by an independent legal expert confirming that the consent provided is valid and enforceable under the relevant applicable laws.

Unlike AIFMD under model 1 (see Part 1 above), supervision is carried out under this model by a European Supervisory Authority (ESMA).

New reporting requirements under MiFIR (Investment Firm Review)

In December 2017, the Commission adopted a proposal for a regulation and a proposal for a directive to amend the current EU prudential rules for investment firms. The aim of the review is to introduce more proportionate and risk-sensitive rules for investment firms. As part of that review, the Commission has suggested the following amendments to MiFIR equivalence regime:

- Reporting requirements for third country firms to ESMA on an annual basis (scale and scope of the services, turnover and value of the assets provided, description of the investor protection arrangement, if there is such an arrangement, and risk management policy of the firms);
- Additional information that the applicant third country firm is asked to provide to ESMA when applying for registration.

The Investment Firm Review does not suggest a ‘dual supervision’ of investment firms along the lines of EMIR 2.2. Unlike AIFMD for asset management and EMIR for clearing, MiFIR does not introduce an ‘authorisation’ process.

Other sectors

The Commission has not proposed further changes to the AIFMD third country passport in its proposal of March 2018 for a regulation on facilitating cross-border distribution of collective investment funds. In accordance with the AIFMD, its forthcoming general review (originally planned for July 2017) will put a particular emphasis on the ‘third country passport’.

In a letter to the European Commission in July 2017, ESMA welcomed the EMIR 2.2 proposal, and stressed that “*depending on the risks posed by third country entities, it is important to have the possibility of supervision at EU level, to ensure efficient and effective supervision and meeting the objectives of investor protection and stable EU financial markets*”. In that context, considering the impact of the UK’s withdrawal from the EU and the “associated emergence of certain third country entities with a potential impact on EU financial stability and investor protection”, ESMA invited the Commission to consider whether similar proposals should be considered for other market infrastructures and key market players, including third country regimes for credit rating agencies, trade repositories, benchmarks, and possibly trading venues, and data providers.

A granular assessment for “systemic” activities

For investment services under MiFID, the Investment Firm Review proposed by Commission in December 2017 suggests upgrading the equivalence assessment by requiring a “detailed and granular assessment” of the “prudential and business conduct requirements” when it comes to services and activities performed by third country firms that are “likely to be of systemic importance for the Union”.

That legislative change proposed by Commission echoes concerns voiced by EBA in its Brexit opinion: "*The Commission should consider ensuring that, when investment firms are established in third countries, they be subject to appropriate conditions for access to the single market including a robust assessment of the equivalence of the prudential standards applicable to them*".

Supervisory cooperation and enforcement

In addition to the MoU between ESMA and third country authorities, EMIR 2.2 (as proposed by the Commission in June 2017) includes a comprehensive framework to ensure the enforcement of ESMA supervisory decisions and other EU requirements. That proposal includes the following elements:

- ESMA has the power to impose fines in case of established infringements by third-country CCPs (Article 25g);
- In terms of supervisory cooperation, ESMA may request third-country competent authorities to carry out specific investigatory tasks and on-site inspections or actively assist the officials and other persons authorised by ESMA in carrying out their supervisory tasks. Officials of the third-country competent authority may also attend on-site inspections.

Unlike EMIR 2.2, the Investment Firm Review proposed by the Commission does not include any changes to the supervisory arrangements that are based on cooperation arrangements (see above).

With EMIR 2.2 that is still being negotiated at Parliament and Council, financial services legislation provides for 4 different models that are summarised below.

Box 3 - Supervision of third country firms under equivalence regimes

Model	Equivalence	Ex post monitoring	Additional authorisation	Application of third country rules/EU rules	Additional requirements
Model 1 - **AIFMD**	Yes Delegated act	**Commission and ESA***	**National authorities** (Member States of reference)	Application of some EU rules (unless rules are equivalent)	Legal representative in the EU
Model 2 - Investment services (**MiFIR**)*	Yes Implementing act **Granular assessment** for systemic activities*	**Commission and ESA***	Registration from ESMA does not come down to additional authorisation	Application of **third country** rules	Reporting to ESMA*
Model 3 - **banking activities**	No	n.a.	n.a.	n.a	n.a
Model 4 - clearing (**EMIR 2.2**)*	Yes Implementing act	**Commission and ESA***	**European Supervisory Authority (ESMA)***	Application of some EU requirements taking account third country rules*	Dual supervision of Tier 2 CCP from ESMA)*

Source: EGOV based on EU legislation and Commission legislative proposals
* As proposed by Commission, under discussion by European Parliament and Council

3. The equivalence regime and Brexit

Loss of 'passporting' rights

When the UK will become a third country - and without prejudice to any transition that may be agreed upon as part of the withdrawal agreement - EU legislation providing 'passporting' rights within the EU will no longer apply to financial services provider established in UK.

In the context of firms' preparedness for the Brexit scenario, the Commission has recently published a number of notices outlining the legal consequences attached to the loss of 'passporting' rights in different financial services legislation, including banking, investment services, derivatives and asset management.

As emphasised by the Commission, firms will need to get a new authorisation (i.e. a new legal entity established in the EU) from EU competent authorities to fully keep the benefit of the internal market (i.e. 'passporting' rights)[8]. This is without prejudice to equivalence decisions that may be adopted by the EU in accordance with specific sector legislation.

European Council and Commission's position on equivalence

The guidelines of the European Council (Art. 50) adopted on 23 March 2018 on the framework for post-Brexit relations with the UK are not financial services specific. For services, the EU Council guidelines specify that provision of services would take place under "host rules", i.e. EU law.

The draft European Council guidelines unveiled by Politico featured a statement in its Annex IV on financial services which called for "*reviewed and improved equivalence mechanisms*" to allow "*appropriate access to financial services markets, while preserving financial stability, the integrity of the single market and the autonomy of decision making in the European Union*". That annex, however, was not part of the final guidelines adopted by the European Council on 23 March 2018. It must be noted

Box 4: Michel Barnier's speech of January 2018

"*A free trade agreement, however ambitious, cannot include all the benefits of the Customs Union and the Single Market. For example, with regard to financial services, a free trade agreement may include provisions on regulatory cooperation – as is the case with Japan. This regulatory cooperation may also take the form of a regular dialogue like the one we have with the United States. But we have never given up our regulatory autonomy. The regulatory framework we have constructed as a Union of 28, including the United Kingdom, learning from the financial crisis, is extremely precise. We have developed a single rulebook and more integrated European supervision, which guarantee financial stability, protection for investors, market integrity and a level playing field. A country leaving this very precise framework and the accompanying supervision gains the ability to diverge from it but by the same token loses the benefits of the Internal Market. Its financial service providers can no longer enjoy the benefits of a passport to the Single Market nor those of a system of generalised equivalence of standards. This is not a question of punishment or revenge; we simply want to remain in charge of our own rules and the way in which they are applied. As it seeks to regain its decision-making autonomy, the United Kingdom must respect ours. Where allowed by our legislation, we will be able to consider some of the United Kingdom's rules as equivalent using a proportionate and risk-based approach, in particular for financial stability, which will remain our main concern*".

[8] : "[At the time of withdrawal,] *UK entities providing banking and payment services will no longer be allowed to provide services in the EU on the basis of their current authorisations*. [A continuation of those services may hence require the] *authorisation as a branch or subsidiary, and potentially result into changes for depositors, for instance where deposit guarantee arrangements would need to change*".

that EMIR 2.2, the ESA review and the Investment Firm Review outlined above have been presented as "adaption measures" for Brexit purposes (see presentation of Task Force 50 on financial services).

Equivalence regimes would be available to the UK after the transition period. During the transition period the *acquis communautaire* with full rights and obligations related to the access to the single market will be applicable. This means that the UK authorised entities will keep their 'passporting' rights during the transition period (see presentation of Task Force 50 on financial services).

Box 5: The Commission's speech of April 2018

Valdis Dombrovskis, European Commission Vice President and responsible for financial services, emphasised in a speech in April 2018 that equivalence was a pragmatic solution for UK after Brexit: *"To sum up: equivalence is not perfect, neither for firms nor for supervisors. But one should not make the perfect be the enemy of good. Equivalence has proven to be a pragmatic solution that works in many different circumstances, and it can work for the UK after Brexit as well"*.

The Chancellor of the Exchequer emphasised in a speech delivered in March 2018 that equivalence regimes "*would be wholly inadequate*" (see box 6) and recalled that the EU already pursued ambitious financial services cooperation in its proposals for TTIP. The Chancellor of the Exchequer called for a "*future partnership in financial services, as part of a wide-ranging Free Trade Agreement*".

It must be noted that when discussing the EU-US trade agreement (TTIP), the Commission suggested in 2014[9] a "*commitment to outcome-based assessments of whether the other party's regulatory and supervisory framework is equivalent*" (see EU negotiating position on financial services for TTIP) that "*could potentially lead to mutual reliance on the rules of the other party*". Nevertheless, the EU did not envisage "*each party making binding declarations of the equivalence of the other's entire regulatory and supervisory framework, but rather carrying out a detailed assessment of the consistency of the implementation of each standard*".

Box 6: The Chancellor of the Exchequer's speech of March 2018

In a speech delivered in March 2018, the Chancellor of the Exchequer, Philip Hammond discarded the equivalence system as a promising way forward and explained that the equivalence regime "*would be wholly inadequate for the scale and complexity of UK-EU financial services trade*". *The following arguments were put forward: "[the equivalence regime] was never meant to carry such a load. The EU regime is unilateral and access can be withdrawn with little to no notice: clearly not a platform on which to base a multi-trillion pound trade relationship*".

Related supervisory challenges

Absent applicable equivalence decisions (or alternative international agreements governing the provision of services), service providers established in the UK would need to relocate into the EU in order to provide financial services across the internal market. In 2017, the ECB warned banks to plan for a worst case scenario (i.e. no withdrawal agreement, no transition and no equivalence) and has since been preparing for all operational aspects related to a possible relocation of UK-based banks to the EU post-Brexit. The ECB has laid down procedures for the relocation of banks to the euro area in the context of Brexit that are kept updated on its web site.

[9] Before the financial crisis, the EU Commission and the US Securities Exchange Commission discussed in 2008 an EU-US "mutual recognition arrangement" that "*would have the potential to facilitate access of EU and US investors to a broader and deeper transatlantic market* [...] *and increase oversight coordination among regulators*".

In that context, the three ESAs, and in particular the EBA in banking and ESMA for investment firms, have adopted Brexit opinions outlining supervisory expectations regarding authorisation and outsourcing arrangements. Those opinions aim at preventing the establishment in the Union of "empty shells" relying on "outsourcing arrangements".

In addition, the issue has been raised as to whether a legal entity established in the EU could serve its EU clients via its branch located in the UK. Both the ECB and ESMA have put limits to "back-branching":

- The ECB has clarified in its frequently asked questions on relocation that the "*ECB and the national supervisors believe that the purpose of branches in third countries is to meet local needs. The ECB and national supervisors do not expect that branches in third countries perform critical functions for the credit institution itself or provide services back to customers based in the EU*";
- Likewise, ESMA in its Brexit opinion has made clear that the use of non-EU branches needs to be based on objective reasons linked to the services provided in the non-EU jurisdiction and does not result in a situation where such non-EU branches perform material functions or provide services back into the EU.

In recent proposals under discussion at Parliament and Council, the Commission has suggested additional requirements for large third-country groups[10] based on specific thresholds related to their activity:

- In CRD2, large third country firms are expected to establish an intermediary parent undertaking (IPU) when they have more than one credit institution or investment firm in the EU (IPU requirement);
- As part of the Investment Firm Review, the Commission has proposed to expand the definition of credit institutions to include large investment firms. The definition of credit institutions would include undertakings whose business includes dealing on own account or underwriting or placing financial instruments on a firm commitment basis, where the total value of the assets of the undertaking is EUR 30 billion or more. Those firms will fall under the direct supervision of SSM.

Where cross-border services is made possible under MiFIR (Article 46 on equivalence regime), there may be a risk that those thresholds could be circumvented by those large third-country groups providing services directly from a third country (and not from their legal entity established in the EU).

In addition, as explained above, equivalence decisions are very much dependent on the supervisory arrangements between EU authorities. The UK has already placed a great emphasis on the degree of cooperation it would expect from the EU competent authorities (see box 7 below).

[10] As emphasised by Commission, investment firms identified as "systemic" are concentrated in the UK, from where they currently provide wholesale market and investment banking services across the EU. These firms are typically subsidiaries of US, Swiss, or Japanese banking groups/broker-dealers.

Box 7: UK authorities' expectations in terms of supervisory cooperation

In its December 2017 consultation paper on branch authorisation and supervision post Brexit, the Bank of England Prudential Regulation Authority (PRA) emphasised that it would place a particular focus on the quality of supervisory cooperation, in particular with respect to EU Member States: "*on the basis of their existing business structures and current degree of supervisability, including the level of supervisory cooperation already in place, the PRA does not expect the new approach to affect any of the non-EEA international banks currently authorised to operate in the UK through branches*".

This consultation document does not contemplate direct access to the UK market from the EU, but outlines conditions for firms to operate in the UK through branches. In terms of supervisory approach, for systemic wholesale branches, the PRA would assess "*the degree of* ***influence and visibility that it has over the supervisory outcomes for the firm as a whole and the wider group***" [our emphasis]. This is meant to ensure that the home state supervisor (i.e. ECB in the Banking Union) "*delivers an outcome that is consistent with the PRA's objective*". Failing appropriate supervisory cooperation mechanism, branches may be requested to 'subsidiarise'.

Other relevant documents published by the European Parliament

- Third-country equivalence in EU banking legislation, A. Margerit, M. Magnus, B. Mesnard, Economic Governance Support Unit, European Parliament, July 2017
- Understanding equivalence and the single passport in financial services, third-country access to the single market, Marcin Szczepanski, European Parliamentary Research Service, February 2017
- The UK's potential withdrawal from the EU and Single Market Access under EU financial services legislation, Dr Olha Chrednychenko, University of Groningen, under the supervision of Policy Department A, European Parliament, January 2017
- Potential concepts for the future EU-UK relationship in financial services, Dr Christos V. Gortsos, Law School, National and Kapodistrian University of Athens, published by Policy Department A, European Parliament, January 2017
- Implications of Brexit on EU Financial Services, European Research Centre for Economic and Financial Governance of the Leiden University, TU Delft and Erasmus University Rotterdam, Policy Department A, European Parliament, June 2017

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