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The voice of banking

What is 'equivalence' and how does it work?

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 It can also be withdrawn, along with any rights that depend on it, at the EU's discretion if a country is judged to have diverged from EU standards for any reason.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

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

Under the EU's existing procedures, securing equivalence can be complex, messy and is rarely fast. A good example of this is the 'recognition' regime for third country central counterparties (CCPs) in the 2012 European Market Infrastructure Regulation (EMIR).

CCPs play an important role in derivatives markets acting as a middle-man between the buyers and sellers of derivative contracts, guaranteeing both sides against the failure of the other. Since the crisis of 2008 regulators have encouraged and required wider use of CCPs. For this reason, the EU has developed a system of recognising CCPs in countries outside the EU that EU firms can use to meet their clearing obligations under EU law.

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

Since 2012 the EU has assessed a number of CCP frameworks around the world and recognised a number of individual CCPs in these markets. In most cases these took a number of years to complete. However, it proved particularly complex when the question was applied to the United States, where many EU banks rely on the CCP provided by the Chicago Mercantile Exchange (CME) to clear 'eurodollar' derivatives protecting them against movements in US interest rates.

- Once the EU's assessments of US CCP rules began, it became clear that US and EU rules in key areas were quite different. EU and US regulators were initially unable to resolve the question of whether the two systems guaranteed similar outcomes, even though they differed in some technical details.
- Negotiations advanced slowly, then stalled, and a deadline for an agreement was ultimately pushed back twice in 2016. At one point, the leadership of the CME, frustrated with the EU's approach to recognition, called for EU firms to be barred from US CCPs.
- After four years, and only with the deadline for mandatory clearing hanging over EU banks, EU regulators finally granted the US system equivalence, and the CME was recognized by ESMA shortly afterwards.
- As a condition of an EU equivalence judgement, the US was required to extend mutual recognition to EU CCPs. The US did this in March 2016 via the 'substituted compliance' procedure it uses to recognizes the supervisory standards of other countries to assess the treatment of US firms operating there. The US process for this mutual recognition was also highly criticized and time consuming to achieve.

Not only will the UK potentially have to navigate this process and others like it with the EU in securing equivalence for itself, but it will need to develop its own domestic regime for recognising the equivalence already granted by the EU to exchanges like the CME. It will also need formal systems for recognising the equivalence of EU rules with its own.

Passporting and equivalence compared: five key EU banking frameworks

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

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