Beyond Brexit: Regulatory equivalence

Irrespective of whether the UK leaves the EU with a withdrawal agreement, interest grows in the future of regulatory policy, the inter-connectivity of international financial services, and how firms from other countries will be welcomed by the main international jurisdictions.

The Bank of England and the UK Financial Conduct Authority have stressed that the UK's withdrawal from the EU should not be an opportunity to race to the bottom in regulatory standards. On the contrary, says FCA chair Charles Randall, "[w]e will need to redouble our engagement with our policymaking and regulatory colleagues in Europe and across the world, to continue to influence global standards of financial regulation".

However, it is unknown to what extent the UK will align or diverge from EU regulation post-Brexit, and whether it will be deemed equivalent. The weight of global standards could mean a degree of inevitable alignment.

There has been increasing globalisation of the financial sector over recent decades. The 2007-8 financial crisis led to a broad consensus for international regulatory standards and increased alignment to strengthen the global financial system. Initiatives are led by the G20, through international standard setters, such as the Basel Committee on Banking Supervision, the International Organisation of Securities Commissions (IOSCO), the International Association of Insurance Supervisors and the Financial Stability Board (FSB).

However, the level playing field has not been as successful as had been initially imagined and there is often divergence in the implementation of international standards. In addition, in the current political climate, it remains to be seen to what extent current international players will follow the ethos of alignment.

The tensions are summed up by the European Commission in its recent Communication on equivalence in the area of financial services:

> *"The EU commitment to global regulatory convergence around international standards is unwavering. At the same time, these global frameworks have a general standard setting purpose and are not always fit for addressing concrete questions emerging in a specific bilateral context."*

This reality is unlikely to change in the foreseeable future. Indeed, both the FSB and IOSCO have recently published research into market fragmentation (which can arise as a result of differences in international regulation and supervision) and cross-border regulation.

Currently, the question of "equivalence", "comparability" or "deference" is tackled on a jurisdiction by jurisdiction basis (albeit by the European Commission in the EU), with varying degrees of economic protectionism.

To combat this protectionism in the EU, the European Commission is moving away from the use of directives as the predominant method by which policy is legislated. Directives allow EU members states discretion in their method of implementation. The Commission increasingly implements policy by regulations, which impose identical laws on EU member states. Even then, disparities in interpretation can manifest.

"Equivalence" relies on a third country being assessed by the European Commission as having a regulatory framework for the relevant financial services product which is equivalent to that of the EU. A positive equivalence assessment can allow non-EEA "third countries" to access the EEA market. In making equivalence assessments, the European Commission is also taking a firmer stance. In addition, the political undertones behind the unilateral equivalency assessment are apparent in the European Commission's acknowledgement that during the process:

> *"...the Commission also needs to consider whether equivalence decisions would be compatible with EU policy priorities in areas such as international sanctions, the fight against money laundering and terrorist financing, tax good governance on a global level or other relevant external policy priorities."*

Despite trends towards economic protectionist globally, in the US, J. Christopher Giancarlo (then Chairman of the Commodity Futures Trading Commission (CFTC)) has given encouraging messages on their equivalence concept in relation to the derivatives markets:

> *"Mutual commitment to cross-border regulatory deference ideally should mean that market participants can rely on one set of rules – in their totality – without fear that another jurisdiction will seek to selectively impose an additional layer of particular regulatory obligations that reflect differences in policy emphasis, or application of local market-driven policy choices beyond the local market. This approach is essential to ensuring strong and stable derivatives markets that support economic growth both in the United States and around the globe."*

It remains to be seen if Giancarlo's vision will become reality. In the same speech Giancarlo acknowledged that the CFTC should seek stricter comparability standards for requirements which address systemic risk. However, this appears to allow for a much narrower scope for protectionism than the wide range of policy issues that the EU permits to influence an equivalence assessment. In any event, systemic risk is a global concern for financial markets.

The UK has historically been relatively permissive in its approach to allowing third country financial institutions into the UK, to the extent permissible under EU law. To help uphold its place as a globally open financial market post-Brexit, it will have to "remain open for business". It is in this context that Andrew Bailey, Chief Executive of the FCA has discussed equivalence and argues for an assessment based on outcomes, not rules:

> *"And, wherever possible, those outcomes should flow from global standards, which should always be the best test of equivalence. Our financial markets are global not regional."*

The UK government is currently calling for input on its review of the future of financial regulation and it will be interesting to see if the UK adopts an outcomes based approach, how this impacts its access to global markets, and whether it uses the approach in its own equivalence assessments post-Brexit. The UK's future vis-à-vis international financial services largely will depend on the how far it aligns with international standards and the protectionist approach adopted by each jurisdiction.

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Toolkit

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