UK FINANCE

What is 'passporting' and why does it matter?

Key points

- The EU passporting system for banks and financial services companies enables firms that are authorised in any EU or EEA state to trade freely in any other with minimal additional authorisation. These passports are the foundation of the EU single market for financial services.
- There are nine different passports that banks and financial services providers rely on in order to provide core banking services to businesses and customers across the EU. To have the benefit of each passport a Member State signs up to and applies a particular regulatory regime into national law.
- These passports are based on the single EU rulebook for financial services and are therefore not available for firms based in countries outside of the EU and the EEA. Non-EU firms face significant regulatory barriers to providing cross-border banking and investment services to customers and counterparties in many EU Member States.
- Certain EU legislation provides for 'third country' regimes which allow non-EU based firms to offer a limited number of services into the EU if their home country regulatory regime is accepted by the EU as being 'equivalent' to EU standards. However, these regimes only apply to a handful of banking services, and are much more limited in scope and in general much less secure than the passporting regime. As a result, they cannot be relied upon to allow non-EU banks to meet all their customers' needs in the EU.
- Once the UK has left the EU and the EEA it would become a "third country" and these limited regimes may in principle be available. For more information, please see BQB #4: 'What is equivalence and how does it work?'

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What is passporting?

Passporting enables firms that are authorised in any EU or EEA state to trade freely in any other with minimal additional authorisation. These passports are the foundation of the EU single market for financial services.

All member states of the European Union are part of the EU single market; the single economic area created by the integration of the markets of the EU states. Goods circulate freely in this market, and businesses established inside it have wide-ranging rights to sell products and services in any part of it. Over time, the EU states have harmonised their rules for many products and services in order to facilitate this trade and to guarantee common standards across the EU.

For over twenty years the scope of the EU single market has increasingly extended into trade in financial services. The foundation of this has been the development of a single EU rulebook for financial services and the increasing harmonisation of standards of financial regulation and supervision across the EU.

Confident in this shared standard, EU states have opened their national markets to the provision of financial services directly from other EU states, or by making it easier to establish branches (instead of more complex and costly legally separate subsidiaries) of banks and financial services firms from other EU states. Once a bank or financial services firm is established and authorised in one EU country, it can apply for the right to provide certain defined services throughout the EU, or to open branches in other countries across the EU, with relatively few additional authorisation requirements. This pan-EU authorisation is its financial services 'passport'.

These passports are not available to 'third country' firms, i.e. firms incorporated outside the EU. Non-EU firms face significant regulatory barriers to providing cross-border banking and investment services to customers in many EU Member States. In many Member States it is either not possible or practical for a non-EU firm to obtain a licence to provide cross-border banking or investment services to local customers. Even if the non-EU firm does obtain a licence to establish a branch in a Member State, that licence will only authorise it to do business in that Member State. It will not confer any rights for the non-EU firm to do business from that branch with customers in other Member States.

There are nine different passports, each covering a different sort of financial service, including core banking services such as lending and deposit taking, market services such as sales and trading, asset management, payments services and electronic money services. Each of these passports is embedded in a particular EU Directive or Regulation establishing the basic rules for that activity. So, for example:

- Corporate banking: A UK-based bank might use its Fourth Capital Requirements Directive (CRD) passport to provide advisory services, lending or custody or deposit services to a business in another EU state. A UK-based bank may also serve clients in the rest of the EU through a branch established in another EU state under the preferential terms created by the passporting framework.

- Market services: A UK-based bank might use its Markets in Financial Instruments Directive (MiFID) passport to help a business in another EU state take a derivatives position to hedge a loan, debt issuance or exchange rate exposure through London-based markets. UK-based banks also use their MiFID passports to help clients buy and sell shares, bonds or other financial instruments and trade on exchanges and trading venues around the EU.

- Private banking: A UK-based bank might use its CRD and MiFID passports to assist a customer in an EU state in arranging a line of credit, managing an investment portfolio, or to advise on financial planning.

- Payments services: Both bank and non-banks based in the UK use the Payments Services Directive (PSD) passport to provide payments services to EU customers.

- Non-UK EU banks using the UK as a hub: Many non-UK EU banks also provide similar services to the above using an operation in the UK to serve clients in their home market or across the single market. To do this they depend on their own passports.

Why does passporting matter?

While each passport covers a separate kind of activity, to enable banks to service the needs of customers and businesses, many modern banking services involve activities covered by more than one passport (see Box 2: Providing Capital to EU businesses).

These passports are the basis of the single market in financial services and are used to enable a steady flow of trade in financial services across the EU. Many banks and financial services businesses in the UK have based their business models on the rights conferred by EU legislation to ‘passport’ their services across the EU and the EEA. They are especially important for the UK, which is the largest exporter of financial services inside the single market, exporting over £20 billion of services to customers in the rest of the EU in 2014 and helping provide hundreds of billions of euros in finance. This trade also supports a wide ecosystem of ancillary services, from legal and business services to data processing and storage.

How does passporting work?

Passporting allows EU-based banks to sell products and services across EU borders and to easily establish branches in other EU countries.

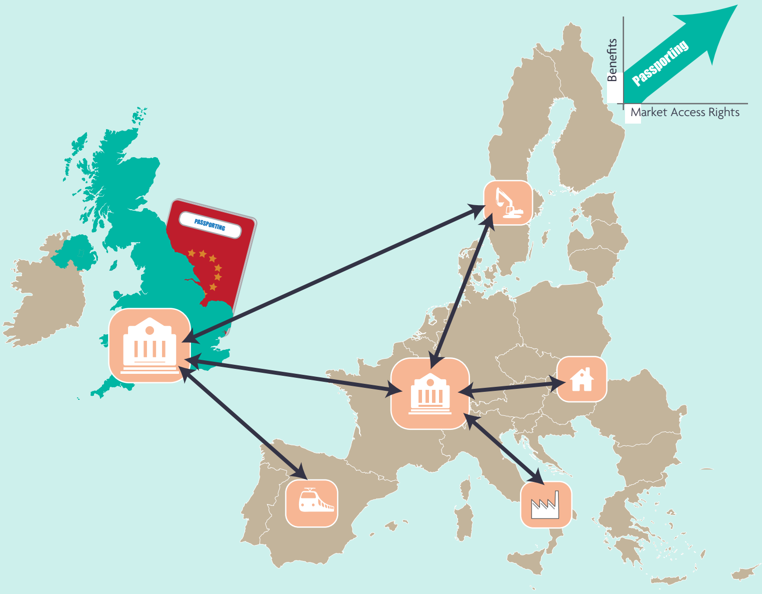
The passporting system is built on the assumption that banks and financial services firms authorised anywhere in the EU will have met the same standards, and thus should in effect be treated as if they were locally authorised. This is reinforced by a very high level of regulatory cooperation between national supervisory authorities in the EU, including the merging of some supervisory functions for EU states participating in the banking union. This is the basis of two important features of passporting:

- It enables banks and financial services firms to sell products and services across EU borders on the same basis as if they were present in the market of sale. This is important for areas such as corporate, investment and private banking, where the customer may be in one EU country, and the bank providing the service in another.
- It enables banks to establish branches in other EU states on preferential terms. Whereas the branches of non-EU banks in EU Member States are treated as ‘foreign’ and are in many cases subject to additional and often comparatively burdensome regulatory requirements not applied to local banks, EU national authorities are generally required to treat branches of banks from other EU states as if they were locally authorised. They are also obliged to defer to the ‘home’ regulator of the branch on some important supervisory issues.

The first of these features enables businesses across the EU to buy financial services directly from the UK. The second has enabled UK-based banks to establish networks of branches in financial centres across the EU, and many banks from other EU states to establish operations in the City of London.

Box 1: Passporting explained.

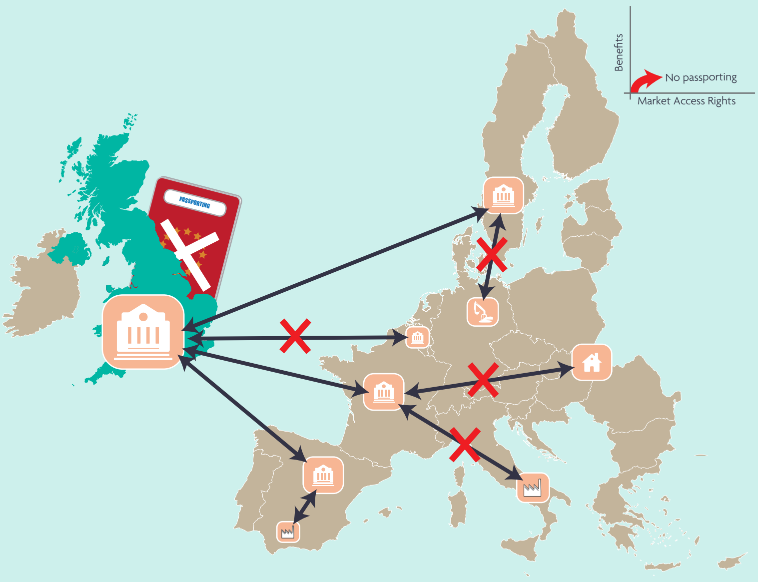
How does passporting work?



A 'passported' UK based bank has broad and well understood rights. It can:

- Provide its customers with the widest range of banking services across the UK and all 27 EU countries.
- Establish a branch in any other EU country from which it can offer cross-border banking services across all other EU countires.
- Do so efficiently, without duplication and at low cost.

What does the loss of passporting mean?



Once outside the EU, a UK based bank has no 'passport rights'. Instead it must apply for a licence for each EU country:

- A licence is not available in many EU countries.
- The range of licenced banking services is much more limited.
- The licence is usually limited to one country at a time (i.e. no cross-border rights).
- Duplication and substantial additional costs.

Can banks based outside the EU obtain passports?

The passporting system has been extended to cover the European Economic Area (EEA), which is comprised of the EU states and Norway, Iceland and Lichtenstein. The extension of passporting privileges to these countries is based on their commitment to honour the basic freedoms of movement, capital, goods and services in the EU Treaties and to incorporate the EU financial services rulebook into their own domestic law.

Banks or financial services businesses from countries outside of the EU and the EEA cannot currently access the passporting regime. To do so they must either establish a regulated business inside the EU or alternatively they may apply for a license under the domestic licencing regime of each individual EU country in which any of them wishes to do business to provide services in that EU country only. Such licenses are not available in all EU countries, provide access only to a limited range of services and generally carry no rights to onward cross-border trade from the country of licensing.

Box 2: Providing capital to EU businesses.

Losing the ability to obtain banking services from the UK would limit the ability of businesses in the EU to obtain the funding they require for growth. This is illustrated in the below example.

A UK based bank provides its customers in the EU an integrated service by combining a number of passporting rights. Losing passport rights can limit the availability of this integrated service.

EU business requires capital

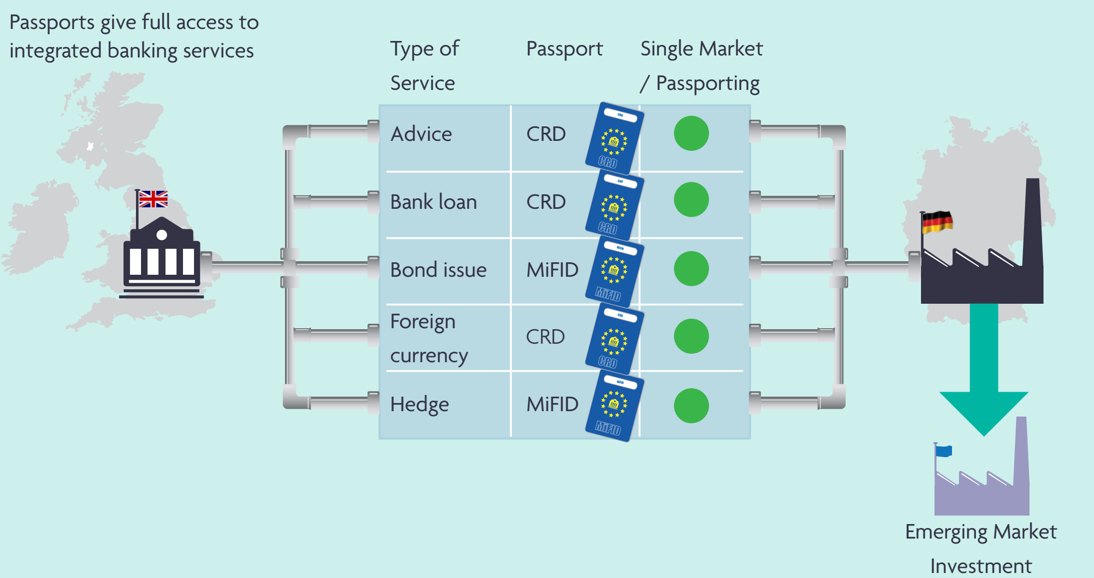
- An industrial company in Germany wants to raise money to upgrade a factory in France and build a new manufacturing facility in an emerging market.

UK-based bank provides capital

- Fund raising advice and bank loan: A UK-based bank uses its CRD passport to both provide corporate advisory services on the financing arrangements and to help arrange a syndicated loan from a group of UK-based banks to the German company.
- Fund raising through a capital market bond: It uses its MiFID passport to assist the German company to sell bonds in the capital markets to secure additional money for the foreign expansion.
- Buy foreign currency: It uses its CRD passport to provide the foreign exchange services required to secure the immediately needed foreign currency for the emerging markets investment.
- Risk management of future currency and interest rate movements: It uses its MiFID passport to help the company hedge its foreign exchange exposure on the non-euro component of the new finance and to hedge its interest rate exposure on both the euro and non-euro components of the financings.

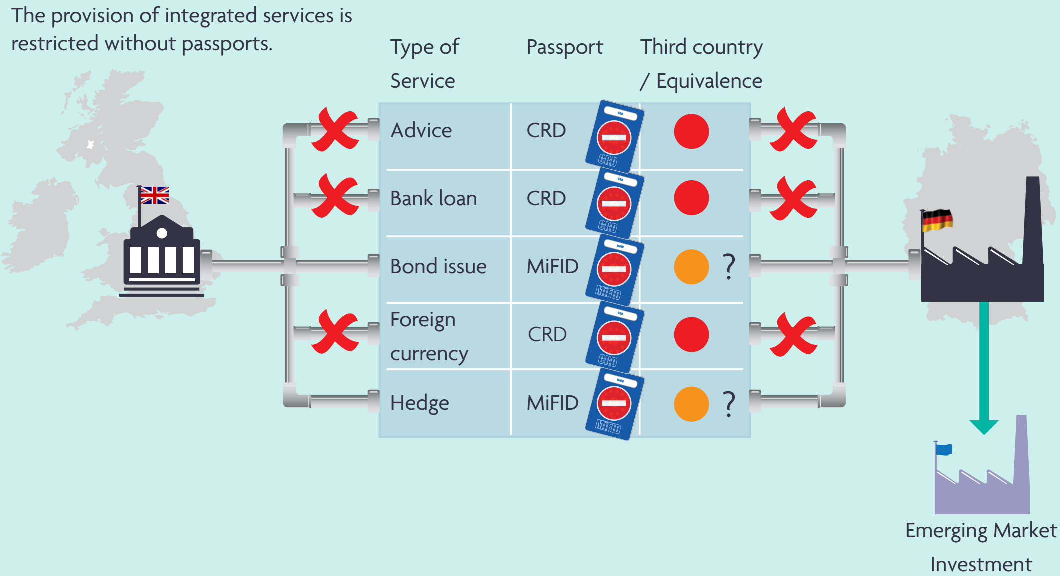
With the benefit of passporting the EU business can access an integrated banking service from the UK based bank and can finance its growth efficiently.

Passporting / Single Market



No Passporting / Third Country Status
Reliance on 'equivalence' or national licencing if available.

Without passporting, the ability to provide these cross border services from the UK to businesses in the EU would be limited and depend upon whether equivalence is granted or the domestic national market access restrictions of individual EU countries.



With the UK outside the single market the EU business' access to banking services will be restricted

- It may be able to only obtain limited financing services from the UK based bank for those services where equivalence is granted or where country-by-country national licensing regimes are available.
- Its funding plan to finance its growth is hurt and it may need to seek financing elsewhere.

The practical consequence of these limitations is that the German customer would no longer be able to obtain from the UK-based bank the fully integrated service it requires to grow its business. The German customer could turn to another bank already based in the EU and able to provide the integrated service via its own passporting rights. Alternatively the UK bank could relocate into the EU the services which it was no longer permitted to provide from outside the EU, resulting in expensive and inefficient duplication.

Leaving the EU/ EEA passporting regime

If the UK leaves both the EU and the EEA it will no longer be covered by the passporting frameworks established by EU directives or the freedoms for trade guaranteed by the EU treaties.

If the UK leaves both the EU and the EEA it will no longer be covered by the passporting frameworks established by EU directives or the freedoms for trade guaranteed by the EU treaties. This would have important potential implications for banks and financial services firms in both the UK and other EU states.

- In principle, it would see UK-based banks lose their ability to sell products and services directly to EEA customers in other EEA states. Instead, the UK-based bank could try to look to the national licensing regimes of individual EEA states. However, relying on the domestic legal position of individual EU countries instead of on the pan-EU passport regime is more limited, complex and costly, and results in a patchwork of outcomes.

  In many cases EU customers would be restricted in their ability to contract with UK-based banks from inside the EU and UK-based banks in their ability to serve EU customers unless they became established and authorised inside the EU – a potential duplication of functions that increases costs and reduces efficiencies. Banks based elsewhere in the EEA would also see their rights to sell services directly to UK customers reduced in many cases – although, this would be an area where UK regulatory authorities would have control over the outcome.
- In principle, it would see the branches of UK-based banks in the rest of the EU revert to the status of 'foreign' bank branches,

Behind these lost operational rights are established services that EU and UK clients and customers depend on, and jobs created to undertake that activity.

with potentially restrictive implications for how they are regulated, what they can do and what prudential requirements they are subject to. This would also be the case for branches of EEA banks in the UK.

- In principle, it would see the branches of EEA banks in the UK lose their own passporting rights back into the EU single market. Given that many of these branches have been established to help EU customers' access London capital and securities markets, this would have a material impact on the ability to serve clients across the EU.

Behind these lost operational rights are established services that EU and UK clients and customers depend on, and jobs created to undertake that activity. These services will need to be restructured, reauthorised and reviewed. That will be disruptive, costly and time-consuming. The ecosystem of other roles that depend on them will be disrupted too. The UK's viability for servicing the single market will fall and this will inevitably impact the jobs created in the UK and the services provided from the UK. This will also disrupt and impact on the rest of the EU.

It has been suggested by some that passporting isn't necessary in wholesale markets, because it only grants the right to sell, and companies in other EU Member States would still have the right to buy. It is true that even without passporting rights a company in Germany could phone up a bank in London unsolicited and ask to buy an interest rate hedging product. But banks in the UK would not be able to market or actively sell to customers in the EU, putting them at a significant commercial disadvantage.

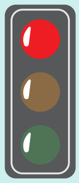
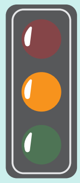
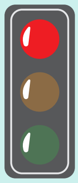
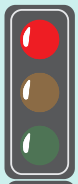
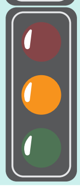
Alternatives to passporting rights

Although these are sometimes referred to as 'passports', they are in no way comparable to the EU passporting system.

The EU does have a very limited number of market access regimes for non-EEA firms in some of its financial services frameworks (see Table 1). Some commentators have suggested that these could be used by the UK once it left the EU and EEA as a substitute to passporting. However, although these are sometimes referred to as 'passports', they are in no way comparable to the EU passporting system. These regimes are more limited, allowing non-EU based firms to offer a restricted number of banking services into the EU if their home country regulatory regime is accepted by the EU as being 'equivalent' to EU standards. In some cases they also require the non-EU country to extend similar equivalence recognition to the EU. Several have not yet been activated by the EU. They also fall far short of the current passporting regime in terms of the operating rights they create and the certainty they provide. They can be withdrawn unilaterally if the EU considers that the other party's regulatory regime no longer provides a sufficiently comparable outcome. As a result, they cannot be relied upon to allow non-EU banks to meet all their customers' needs in the EU.

For more information, please see BQB #4: 'What is equivalence and how does it work?'

Table 1: Some key EU passports for banking services

Activity	Bank Located inside EU/EEA EU/EEA passport	Bank located outside EU/EEA Current equivalence framework for firms based outside the EU/EEA
Lending, deposit taking and other core banking functions.	Yes -- the Capital Requirements Directive (CRD). 	No. 
Investment services eg. derivatives and hedging products such as FX and interest rate hedges used by businesses to manage risk.	Yes -- the Market in Financial Instruments Directive (MiFID). 	Limited -- some potential limited rights in MiFID2 for non-EEA firms, subject to equivalence, but MiFID2 framework not yet fully implemented. 
Credit cards, payments and e-money.	Yes -- the Payment Services Directive (PSD) and E-Money. 	No. 
Asset management.	Yes -- the Undertakings for Collective Investment in Transferable Securities (UCITS) framework for investment products and Alternative Investment Fund Managers Directives (AIFMD). 	No – under UCITS  Limited – under AIFMD, for non-EEA Alternative Investment Funds, subject to equivalence. However, this framework for non-EEA countries has not yet been activated. 
Note that the provision of many banking services ultimately relies on more than one passport – for example many ‘integrated’ corporate banking services involve activities covered by MiFID and CRD passports.		

See also

BQB # 1 Staying in or leaving the EU Single Market.
BQB # 2 An orderly exit from the EU
BQB # 4 What is equivalence and how does it work?
BQB # 5 Data protection and transfer.
BQB # 6 Time to adapt – the need for transitional arrangements.
BQB # 7 The Repeal Bill explained.
BQB # 8 External trade policy and a UK exit from the EU - clarifying the UK’s WTO profile and beyond.
BQB # 9 Impact of Brexit on cross-border financial services contracts
BQB # 10 Towards a framework for financial services in an EU - UK Free Trade Agreement