The Implication of Brexit on Single Banking Passport

Ze Wang

Department of Law, Stockholm University, Stockholm, SE-106 91 Stockholm, Sweden

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Abstract: In the UK, nearly five-and-a-half thousand British companies hold passport under various Single Market directives, which means the authorized firms will have the power to provide certain regulated financial services in one European Economic Area (EEA) member state, and they do not need to obtain other EEA member state’s separate authorization to provide certain regulated financial service. At the same time, nearly eight thousand companies from the EEA entered the UK with the passport. In addition to the UK and other EEA member states, many third countries’ financial institutions that obtain single passport in the UK will inevitably be affected by the Brexit. It is not surprising that the change of passport power has attracted considerable attention. With the promotion of Brexit, the pattern of European banking industry will also change. The gradually differentiated regulatory environment will also become a big challenge for many large international banks. This paper aims to evaluate the impact of Brexit on the banking industry, specifically for many large international banks.

1. Introduction

Since the end of the Brexit referendum in 2006, as the center of financial services, the development of banking industry has shown a new development tendency. Before the final agreement is reached, the right of the single banking passport and the change of the regulatory environment have been the focus of heated discussion. The change of the single passport mechanism will force many large international banks to make adjustments and changes. Based on the importance of the single banking passport to the international banks, this article will mainly evaluate the implication of Brexit on single banking passport from the definition of banking passport, the impact of Brexit on the passporting rights for UK banks and the path of the impact of Brexit on UK-based EU banks and UK-based third country banks.

2. The explication of the single banking passport

All EU Member States jointly constitute the EU single market, enterprises established in the internal market are allowed to sell products and provide financial services in other Member States, so that goods and capital can flow freely in the single market. Over time, the EU states have harmonized their rules for many products and services in order to facilitate this trade and to guarantee common standards across the EU. The liberalization of banking and financial services is not achieved overnight. Applying single passport rights in financial services began in the late 1980s and early 1990s.[1] Through the continuous improvement of the financial supervision system, Member States...
that are confident in establishing a common internal market have directly provided financial services to other Member States, opened their markets, or by transforming domestic laws, banks and financial institutions in other Member States can establish branches without cumbersome procedures and harsh conditions. This means that once a bank or financial institution is authorized in an EU Member State, it can provide authorized financial services in the single market, or the access requirements for opening branches in other Member States will be reduced.\[^{2}\] In general, the EU passport for banks and financial services companies enables firms that are authorized 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. However, when this passport system is applied to “third country” financial institutions, the situation is different. Compared to EU firms, it is relatively difficult for “third country” firms to provide financial services freely in the EU internal market. Because if they want to obtain the passports, they will go through more strict and cumbersome procedures, and the passports they are obtained often only authorize them to carry out financial business in this country, if they want to provide financial services in other EU Member States, they will need to be authorized in other country again.\[^{3}\]

2.1. Different kinds of passports

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. A UK-based bank may also serve clients in the rest of the EU Member States through a branch established in another EU state under the preferential terms created by the passporting framework; in terms of 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 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.

In addition, London as the financial center of the world, many non-UK EU banks take the UK as the center of their business. Lots of non-UK EU banks use their passports to provide financial services to their customers in the domestic market or the whole single market through their business in the UK.

2.2. The significant of single passport

The exercise of the passport has greatly promoted the free movement of capital. European banks with the right of passport do not need to set up separate subsidiaries throughout the European Economic Area, but since subsidiaries are independent legal entities with their own balance sheets, they need to meet capital requirements and pay local taxes. In contrast, it is more convenient to operate a branch under the passport system, and the branch provides services outside one Member State of the whole European Economic Area with more time and efficiency advantages.\[^{4}\] Meanwhile 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.\[^{4}\] 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 service 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.[5] This trade also supports a wide ecosystem of ancillary services, from legal and business services to data processing and storage.[5]

2.3. EU single passport for third country banks and financial institutions

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. 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.[7] 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.

If a third country bank or financial institution wants to provide financial services in the EU, it must first apply to the authorities of a Member State for appropriate regulatory license, authorization or approval. Only the institution is authorized that can provide corresponding financial services within the EU. A single passport is the basis for banks or financial institutions to provide financial services in the single market. According to the Capital Requirements Directive (CRD IV), a single passport enables authorized banks or financial institutions to provide cross-border services in the EU economic area by establishing local branches.

3. The impact of Brexit on the passporting rights for UK banks

As a Member State, the UK had fully implemented the EU financial laws into its domestic legal system. The CRD IV was transposed into UK law by a series of legal acts.[8]

The Financial Services Authority (FSA) which was established in 2001 to supervise the market was replaced by a twin supervisory system comprising of the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA). Initially the PRA was set up as a subsidiary of the Bank of England (BoE) but after the Financial Services Act 2016, the Prudential Regulation Committee (PRC) within the BoE to exercise the functions instead of the PRA.[9] Currently, the PRC is responsible for promoting the prudent operation of the credit institutions, insurers and investment banks. The FCA act as the competent authority for the prudential regulation of investment firms that are authorised following the adoption of the MiFID. The task of the FCA is to regulate the retail and wholesale financial markets, protect the investors and promote competition in the market. It also regulates the financial entities that do not specifically fall under the scope of the PRC. After Brexit, the EU system of home and host state control system will cease to apply in the UK. It will be the twin authorities that will be responsible for the supervision even of the EU banks operating in the UK.

A UK bank that was incorporated in accordance with CRD IV is entitled to a single passport. In the UK, competence is assigned to the PRC to decide on the applications for a banking licence to provide services not only within the UK but across the EU by a European single passport.[9] The validity of such passports will arise only after the expiry of the transitional period or both parties mutually agree to extend the deadline or the talks break down prematurely.

Once the Brexit process is finalized, there is a risk of disruption of the uninterrupted four-decade long close link that existed between the UK and EU financial markets.[10] The privilege enjoyed by the UK-based banks to provide services across the English Channel may come to an end post-Brexit. A mixture of complex issues surrounding the single passporting system will be ignited by the departure of the UK from the EU.[11]
3.1. Shaking the status of London as a financial center

The initial negative impact on the UK resulting from Brexit is the withdrawal of an important EU agency, the European Banking Authority (EBA) from London. In 2011, when a location for the establishment of the EBA was explored, London became an obvious choice as its principal place of residence.

The shifting of the EBA out of London may remove or at least limit the influence the UK had over the rules governing matters relating to the EU banking system. The EBA does not operate in isolation but is largely influenced by the financial environment in which it exists. It is a powerful EU agency responsible for setting standards for EU banks, decides how to calculate potential losses on risky loans, carry out bank stress test to safeguard the financial system etc. According to a former chairperson of the EBA: “The EBA move out of the UK makes clear that in the future the UK will no longer have a seat at the table when the EU determines the rules that govern EU finance.”.

After Brexit, there is no choice but to shift the EBA from London to an EU Member State. There were several Member States that lobbied to host the EBA but ultimately the beneficiary was Paris, which also host another important EU financial supervisory agency, the European Securities and Market Authority (ESMA).

3.2. The implications of the Trade and Cooperation Agreement (TCA) for financial services

The EU–UK Trade and Cooperation Agreement (TCA) is a free trade agreement signed on 30 December 2020, between the European Union (EU), the European Atomic Energy Community (Euratom), and the United Kingdom (UK). The Trade and Cooperation Agreement (TCA) does not provide a comprehensive free trade arrangement for financial services between the EU and the UK. In particular, the TCA contains no measures to offset the loss of the EU-wide licensing cover UK firms previously enjoyed under a “passport”. This key benefit to being within the EU single market for financial services had meant that London was selected as the location of choice for many firms and served as the main gateway to access the EU market.

For the UK financial institutions, the core problem is the TCA does not provide a solution to offset the loss of access to the EU market that UK firms previously enjoyed. Work is ongoing to establish a framework based on equivalence, but the outcome is uncertain and likely to be uneven across financial services.

Possible solutions to replace the loss of passporting rights, such as enhanced equivalence or mutual recognition arrangements, did not gain traction in negotiations with the EU. Even the prior nonbinding commitments on both sides to implement the existing (and limited) equivalence provisions did not materialize in the TCA (although, as set out below, equivalence provisions do form part of the discussions around the memorandum of understanding between the EU and the UK that the parties hope to be concluded by the end of the first quarter). Instead, the TCA contains a commitment for both parties to implement international standards (e.g., the Basel Committee’s standards relating to the banking sector). This does not introduce any meaningful obligation, as both the UK and EU are already committed not only to adhere to international standards but also to participate in standard-setting bodies. There is also a provision requiring the maintenance of access to each other’s payment and clearing systems run by central banks and other public authorities, as well as to establish a structure for regulatory cooperation between the two jurisdictions as set out in the Joint Declaration on Financial Services Regulatory Cooperation Between the EU and the UK (Joint Declaration) that was published alongside the TCA.

Accordingly, UK firms which previously enjoyed unhindered access to the EU market under the passport are effectively faced with a “hard Brexit” scenario. Such firms must now establish a licensed entity in the EU or augment the use of an existing EU-based entity. Alternatively, they will
have to rely on licensing exemptions to the extent they are available. Most Member States have not implemented meaningful exemptions from their regulatory licensing regimes that would be available to UK-based firms. Many larger UK banks and broker-dealers planned their post-Brexit business on the basis of a hard Brexit scenario and have already restructured their operations, but many smaller UK firms have not taken these steps due to the costs involved and additional resources required.

The EU has granted temporary equivalence for central counterparties and central securities depositories authorized in the UK, thus preserving access to critical UK financial market infrastructure. This measure is intended to alleviate the difficulties EU-based firms face when switching to an alternative clearing or settlement provider in the EU which may not yet be available, rather than to confer any benefit to UK clearinghouses and settlement systems. Some individual EU member states, such as the Netherlands and Italy, have put in place temporary, limited arrangements to enable UK firms to continue providing services to wholesale clients in their jurisdictions. Some UK firms are also relying on “reverse solicitation” (i.e., an unsolicited instruction by the EU-based customer to the UK firm to provide services) in order to avoid licensing. However, there is ongoing scrutiny by the EU in relation to misuse or excessive reliance on this as a means of avoiding licensing.

From the European perspective, EU firms seeking to provide cross-border services in the UK are also impacted by the hard Brexit approach and the loss of the passport in terms of accessing the UK market. The UK has adopted measures to ease the transition for these EU firms, including the Temporary Permissions Regime which affords a license for a limited time until a stand-alone UK license is obtained. Temporary licensing cover is also afforded to those EU firms intending to wind down business and exit the UK market. Ultimately, EU firms seeking to do business in the UK will be required to have appropriate UK licenses or rely on an exemption to provide financial services to UK customers. The UK has unilaterally granted equivalence determinations in many but not all sectors, which will benefit EU firms in certain contexts (e.g., when acting as market-makers subject to the UK Short Selling Regulation) as well as UK firms in some respects. For instance, as a result of the UK’s equivalence measures, UK banks and broker-dealers will not be penalised for their credit exposures to EU counterparties relative to UK counterparties.

The UK has chosen not to implement the full range of equivalence measures which could have been adopted as, in the UK’s view, granting equivalence in certain areas without reciprocity from the EU would not be beneficial for UK firms. On this basis, the UK has chosen not to grant equivalence enabling EU broker-dealer firms to provide investment services in the UK on a cross-border basis. There is also no equivalence for EU trading venues for the purposes of the UK’s equities and derivatives trading obligation. This has had the effect of bifurcating UK and EU markets and adversely affecting the liquidity of many financial products. Therefore, it has to be said that the British version of the existing EU financial services legislation has caused duplication and conflict in some areas, which has brought a lot of confusion and uncertainty.

4. The path of the impact of Brexit on UK-based EU banks and UK-based third country banks

4.1. The UK-based EU banks

The free movement of economic freedoms within the single market is not a one-way process. However, in the field of financial services, London had attracted more banks and other financial institutions from the EU countries than in the opposite direction. It is not only the UK banks that will lose their single passport post-Brexit but a similar fate will also fall on the EU banks providing services in the UK.

In post-Brexit, UK branches of EU/EEA banks must apply for fresh authorisation if they are to continue their operations. As highlighted, the need for further authorisation was abolished by SBD
and substituted the principle of mutual recognition. However, since the UK banking law is largely a reproduction of CRD IV, it may be assumed that the authorisation conditions may be the same even post-Brexit. In terms of CRD IV, the supervisors of the home state of an EU-based bank that operates a branch in the UK is responsible for the prudential supervision. The PRC had limited competence to supervise the EU banks operating in the UK. If an EU branch is treated as significant in terms of the CRD IV, the PRC may take precautionary measures over branches in exceptional situations.

After Brexit, the UK will not be bound by the EU rules that demarcates the competences between the home and host state. In post-Brexit, the PRC and FCA will be the sole supervisory authorities. Even EU bank branches will be treated the same way as any other international bank branches for purposes of prudential supervision.

The legal position will not be different even with third country banks established in an EU Member State. They too will be deprived of their single passport to provide banking services in the UK. The subsidiaries of third countries domiciled in a Member State will continue to exercise their passporting rights within the Union. In post-Brexit, the EU based third country banks, asset managers, payment firms and insurers have to establish offices in the UK if they are to serve their local clients.

4.2. The UK-based third country banks

London had been the most preferable location for international banks and other financial institutions to access the EU markets and customers. London succeeded Amsterdam, the capital of the UK’s colonial arch rival Holland, as the world’s trading and financial center in the 17th century. Since then London had been holding on to its position as a dominant financial center, especially in Europe. For more than four decades, London had often been selected by third country service providers such as banks, insurance companies and investment funds as their base to provide cross-border services by a single passport.

Apart from being the financial capital of the EU, London is also blessed with a unique financial ecosystem of ancillary services, which places it at an advantage over its continental competitors. In terms of access and availability of human capital, modern and well-equipped financial market infrastructure and market reputation, London may be placed ahead of the other EU financial centers such as Frankfurt, Milan and Paris. There are more than a million people representing multiple nationalities who work in the UK financial sector. If those who provide ancillary services to the financial market such as accountants, lawyers and financial advisers are accounted, the strength of the work force may exceed 2 million.

Another strategic advantage of London is its location, placed in an international time zone, with trading hours overlapping the markets in Asia, the Middle East and US. The well-tested and reputed common law legal system with clear and precise rules to protect creditor and shareholders’ rights is another attraction of the UK for international service providers. English language that links the global financial market is obviously another advantage for international firms to set up a secondary establishment in London. Furthermore, London’s prominent position in global finance was no doubt further enhanced by the deregulation of the EU’s financial market.

A third country bank can establish a subsidiary or an equivalent legal entity within the EU and thereby acquire a single passport. It is this privileged position that enabled international banks to access the EU financial market with a subsidiary established in the UK. The greatest benefit the third country banks enjoyed by setting up a secondary establishment in London is the easy access to the EU financial market and customers using a single passport.

With the finalizing of the Brexit process, third country banks domiciled in the UK will lose their single passport. Even if the UK succeeds in retaining the single passport, it cannot pass on the benefits to third country banks domiciled in the UK. The current position of London as a global
financial center may thus lose its glamour in view of Brexit. In post-Brexit, international banks using
UK as their EU entry point may have to review their operations. An option which is already being
exercised by third country banks is to relocate their operations to some financial centers like Paris,
Brussels, Frankfurt and Dublin.

It is unlikely that the EU will agree to third country banks using the UK as their platform to provide
their services into the EU. If a third country is given such a right, it will be difficult for the EU to
secure similar market access to its banks in such countries. If a third country bank operates from the
UK with a single passport to provide services into the Union, it can also lead to market distortion in
relation to the flow of financial services between the EU and third countries.

CRD IV allows even third country banks established as a subsidiary in a Member State and thereby
secure market access to the entire EU financial market. A similar right of market access cannot be
secured for the EU banks in a third country if the UK-based PRC is authorized to issue a single
passport to third country banks.\(^5\) Since close cooperation between the EU and UK authorities on
regulation and supervision will cease post-Brexit, it is not possible for the UK to guarantee market
access to EU banks in third countries.

5. Conclusion

Apart from immigration, fisheries and competition, another complex policy area for negotiations
between the UK and EU will be in the field of financial services. Over the last four decades, the UK
was a major beneficiary of the open, rich and dynamic EU’s financial market. The concept of single
passport was the brain child of the UK and, ironically, it will be deprived of its benefits due to its
unilateral action to leave the EU.

The change of passport mechanism and the differentiated regulatory environment have had a
significant impact on many international banks. For most UK banks, whether the UK and the EU will
agree and what kind of agreement they will agree to regulate their trade relations after Brexit is their
top priority. But whatever the nature of agreement they may agree, what could be predicted with some
degree of certainty is that in post-Brexit the UK will lose its single passport unless the parties agree
to extend its validity. In the light of this pessimistic outlook, the options for the UK to reclaim the
single passport is extremely limited. And the Brexit effect on the single passporting system will be
of a triangular dimension. The EU banks providing services in the UK will also be in a similar
dilemma. The third country banks based in the UK will also lose their single passport.

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