IPOL | DIRECTORATE-GENERAL FOR INTERNAL POLICIES
EGOV | ECONOMIC GOVERNANCE SUPPORT UNIT

European Parliament

BRIEFING

Third-country equivalence in EU banking legislation

This briefing focuses on the concept of equivalence in EU banking legislation and notably on the difference between "passporting" rights and "third-country equivalence" rights. It gives an overview of existing equivalence clauses in some key EU banking and financial legislation and of equivalence decisions adopted by the European Commission to date. The briefing will be regularly updated.

What is the difference between 'passport' and 'equivalence'?

The principle of free movement of services stems from the Treaty. It has been further specified in EU secondary law where the concept of 'passport' has gradually emerged. In the field of banking and other financial services, the passport gives banks in the EU the right to provide financial services throughout the EU, under the license granted by their home country and under the home country supervision. The passport relies on two elements: i) a set of prudential requirements harmonised under EU law; and ii) mutual recognition of licenses.

The EU passport is particularly well-established in banking services. Passporting rights for banking activities were formalised into EU law by the second banking directive in 1989. The banking passport allows banks to provide banking services throughout the EU, either directly from their home country or via branches established in another Member State that do not require the authorization of the host Member States. Under the EU passport regime, there is no need to open a fully-fledged local subsidiary to provide banking services in another Member State. Subsidiaries are separate legal entities subject to host country licensing and supervision that have to meet capital requirements on a solo basis. Using passporting rights to operate branches is more time and cost effective. EU Member States have full access to the Single Market and benefit from all passporting rights. Beyond the EU, passporting rights are only available to members of the European Economic Area (See Box 1).

Box 1: The European Economic Area (EEA)

The Agreement on the EEA entered into force on 1 January 1994. It brings together the EU Member States and Iceland, Liechtenstein and Norway in a single market. It is based on the principle that all the EU legislation that is relevant to the Agreement should be implemented by EEA members. It covers the four freedoms, i.e. the free movement of goods, capital, services and persons, plus competition and state aid rules and horizontal areas related to the four freedoms.

The EEA Agreement does not cover the following EU policies: common agriculture and fisheries policies; customs union; common trade policy; common foreign and security policy; justice and home affairs; direct and indirect taxation; or economic and monetary union.

The EEA States contribute to the EU operational costs (alongside Switzerland, which is part of the European Free Trade Association - EFTA). In 2016, the total EFTA-EEA contribution to the EU budget amounted to EUR 409.2 million, according to the EFTA annual report 2016.

To date, there is no precedent of passporting rights without full membership of the EU or acceptance of all relevant EU rules and regulations (EEA model). The EU passport as such is not available to financial institutions established in "third-countries" (i.e. a country not being part of the EU or the EEA).

12 July 2017 Contact: egov@ep.europa.eu PE 587.369

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However third countries are entitled to ask for the so-called "equivalence" treatment by the EU. As opposed to the EU passport, the concept of third country equivalence is a much more piecemeal approach (See Box 2). Equivalence can only be requested by third countries where it is explicitly provided for in EU legislation (since it is not available with respect to the provision of all services, or the servicing of all client types). Equivalence provisions are tailored to the needs of each specific act and their meaning varies from one legal text to another. Equivalence is assessed by the Commission. Theoretically equivalence can be withdrawn at any time (although there is no precedent so far).

Box 2: Passport vs equivalence

	PASSPORT	EQUIVALENCE
Legal base	EU Treaty + secondary law	EU secondary law
Rights granted	Free provision of financial services	Narrowly defined in the relevant articles
Beneficiary	Institutions established in EU Member States and EEA	Institutions established in Third-country (following assessment by COM)
Length	Permanent	Can be withdrawn

Source: EGOV

According to the European Commission, equivalence clauses are made for the mutual benefit of both EU and third country financial markets and institutions. As underlined in the recitals of the relevant legislative acts, equivalence clauses support three objectives:

- they reduce or even eliminate overlaps in regulatory compliance for the EU and/or the third-country entities concerned,
- they lead to considering certain services / products / activities of third countries' firms as compliant with various objectives of the EU regulatory framework,
- they allow to apply a less burdensome prudential regime in relation to EU financial institutions' exposures to an equivalent third country.

Equivalence is therefore often conditional on reciprocity by the third-country. For businesses and countries not governed by an equivalence regime, third country institutions or service providers must file for authorisation by the competent supervisor in each Member State where they plan to operate.

Equivalence clauses in EU banking legislation

Whether or not equivalence is available -and what it implies- varies across EU legislations. In some cases, the legislation includes a "third country regime" which allows non-EEA firms to provide services into the EEA if their home country regulatory regime is "equivalent" to EU standards. In most cases, equivalence clauses serve other limited purposes (e.g. risk-weights to be applied by EU financial institutions to exposures to third-country firms for the calculation of prudential ratios). As explained in the Commission Staff Working Document '*EU equivalence decisions in financial services policy: an assessment*' (SWD) published on 27 February 2017: '*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'*.

Overall, as regards access to the Single Market for third-country financial services providers, the situation can be summarised as follows (See table 1 overleaf- for a more detailed analysis, see table in the Annex).

- If wholesale financial services may benefit from passport-like rights under equivalence clauses in specific cases, this is never provided for retail financial activities;
- It is noteworthy that the Capital Requirements Directive and Regulation (CRD IV/CRR) do not provide any passport-like rights for third countries, even for wholesale banking business.

CRD IV/CRR equivalence is limited to the prudential treatment of certain types of exposures to entities located in non-EU countries. It allows EU based institutions to apply preferential risk weights to the relevant exposures in third countries whose prudential supervisors and requirements are deemed equivalent to the EU by the Commission. CRR equivalence clauses are irrelevant in terms of EU market access for third country firms;

- The directive on Undertakings for the Collective Investment of Transferable securities (UCITS) does not provide for any possibility of access to the Single Market for third country fund; UCITS funds, which are marketed for retail clients, should be domiciled in the EU;
- The Markets in Financial Instruments Directive (MIFID), the Alternative Investment Fund Managers Directive (AIFMD, Solvency II and the European Markets Infrastructures Regulation (EMIR) provide for a limited access to the Single Market for third-country financial services providers, under strict conditions and in order to service wholesale clients only; the latest proposal for a revision of EMIR tabled by the Commission on 13 June 2017 aims however at restricting the conditions of access to the Single Market for Central Clearing Counterparties located in third-countries (See box 3).

Table 1: Overview of equivalence clauses (*Source: EGOV, Commission 2016***)**

Financial service	EU legislation	Are there equivalence clauses?	Do they grant access to the Single Market ('passport-like')?
Banking	**MIFID/MIFIR** (*investment services and activities)*	**YES**	**YES, PARTIALLY** *(If equivalence is granted, third-country firms can operate anywhere in the EU to serve professional clients)*
	CRD IV/CRR *(wholesale and retail commercial banking*	**YES**	**NO** *(equivalence only covers the prudential treatment of exposures to foreign institutions)*
Asset Management	**AIFMD** *(Non-UCITS Funds marketed to professional clients)*	**YES**	**YES** *(possibility of extending the passport to non-EU fund managers – based on "positive advice" from ESMA)*
	UCITS *(EU-domiciled funds marketed to retail clients*	**NO**	**NO**
Insurance	**Solvency II** *(insurance and re-insurance activities)*	**YES**	**YES, PARTIALLY** (*if equivalence granted, passport-like rights for reinsurance companies only)*
Market infrastructure	**EMIR** *(central clearing counterparties- CCPs)*	**YES**	**YES** *(if equivalence is granted, passport-like rights for central clearing counterparties- CCP)*

Box 3: Commission's regulatory proposal amending EMIR of 13 June 2017

To better address the potential risks to the EU's financial stability, the Commission proposes to enhance the current framework for the recognition of third-country CCPs and their supervision. The proposal introduces a two-tier system:

- Non-systemically important CCPs would continue to be able to operate under the existing EMIR equivalence framework;
- Systemically important CCPs would be subject to stricter requirements. A limited number of systemically important CCPs may be of such systemic importance that the requirements are deemed insufficient to mitigate the potential risks. In such cases, a decision may be taken allowing a CCP to provide services in the Union only if it is authorised under EMIR and established itself in the EU.

ESMA would decide if a third-country CCP is systemically important. In cases where a CCP would be deemed "*substantially systemically important*", ESMA would make a recommendation to the Commission, in agreement with the relevant central banks. On that basis, the Commission may adopt an implementing act declaring that the CCP in question may only provide services in the Union if it is authorised (and established) in the EU.

Assessing equivalence

The European Commission (DG FISMA) is responsible for carrying out technical assessments of equivalence. These decisions are sometimes based on advice from the three European Supervisory Authorities (EBA, EIOPA, and ESMA). The above mentioned Commission Staff Working Document (SWD) gives an overview of the process followed by the Commission to assess the equivalence. As explained in the SWD, equivalence provisions typically require verification by means of an assessment that a third-country framework is equivalent to the EU regime in the following aspects:

i) the requirements under assessment are legally binding;

ii) they are subject to effective supervision by local authorities;

iii) they achieve the same results as EU rules.

If equivalence provisions set the criteria according to which the Commission's assessment should be conducted, they also confer to the Commission discretion whether to grant equivalence or not. Third countries can express an interest in being assessed but the Commission is under no obligation to act.

Assessments of equivalence involve a close exchange of information with third-country competent authorities. Equivalence decisions usually take the form of an implementing act. While the European Parliament has no formal role in the adoption of equivalence decisions, its observers are invited to the meetings of the so-called Regulatory Committee -composed of representatives of Member States- which examines the Commission draft decision on equivalence. The decision may specify whether equivalence is granted in full or partially, for an indefinite period until withdrawal or with a time limit.

Following an equivalence decision under some regulations (e.g. EMIR, MIFIR), individual firms have to apply for recognition from European Securities and Markets Authority (ESMA). The timeline required to obtain an equivalence decision varies across cases as the Commission is under no specific obligation to decide under a specific deadline. The European Market Infrastructure Regulation (EMIR), for example, entered into force in August 2012. It took up to 4 years for the Commission to assess the equivalence regime of CCPs located in the United States before taking its decision in March 2016 (for a detailed overview of Commission equivalence decisions, see table in Annex). According to the SWD, COM has adopted 212 equivalence decisions covering a total of 32 countries. Japan, US and Canada are the countries with the highest number of equivalence decisions.

Box 4: Judicial control

- The Court of Justice of the European Union (CJEU), as the judicial authority of the European Union, **has jurisdiction over all EU acts**. As such, it ultimately ensures the correct interpretation of primary and secondary EU law, and assesses validity of secondary law, within the limits foreseen in the Treaties. In particular, under the specific legal conditions laid down in Articles 263, 265, 267 TFEU, the CJEU is competent to adjudge actions for annulment or give preliminary rulings pertaining to passporting rights in accordance with the fundamental freedoms guaranteed in the Treaties, and in the light of EU directives or regulations establishing the basic rules for particular economic activities.

- The European Free Trade Area (EFTA) Court is an *ad-hoc* **international court which has jurisdiction with regards to EFTA States** that are parties to the EEA agreement (at present Iceland, Liechtenstein and Norway). The court is mainly competent to deal with infringement actions against an EFTA State with regard to the implementation, application or interpretation of EEA law rules. Thus the jurisdiction of the EFTA Court largely corresponds to the jurisdiction of the CJEU over EU States, including passporting rights which are extended to EEA countries.

- The competence of the CJEU over the **equivalence framework** would depend on the case at hand. In theory the legality of an equivalence decision taken by the Commission can be reviewed by the CJEU (263 TFEU), as for any decision taken by the Commission. The CJEU has jurisdiction when a Member State or an EU institution or, where the act is of direct and individual concern to them, natural/legal persons *(from an EU or a non-EU country)* challenge the legality of an equivalence decision based on specific legal grounds. The situation is different in the case of inaction by the Commission. If the Commission does not take any decision and is under no obligation to do so, possibilities for a legal action appear limited in the absence of a challengeable act.

Other relevant documents published by the European Parliament:

- 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, 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, under the supervision of Policy Department A, January 2017

Annex:
Equivalence Decisions taken by the European Commission (as of 21/12/2016)

(Source: European Commission)

EU Legislation	Legal base	Are these 'passport-like' rights?	COM equivalence decisions
Markets in Financial Instruments Regulation (MiFIR) (No. 2016/1033, 2014/600) /Markets in Financial Instruments Directive (MIFID2) (No. 2016/1034)	**Art 1 (9) MIFIR : central bank exemption** *Transactions with central banks from third-countries can be exempted from the scope of the regulation (in the same way as transactions with the European System of Central Banks)*	**No**	**No equivalence decision has been adopted** **(**MiFIR and MIFID II enter into application in January 2018)
	Art. 23 and 28 MIFIR: Obligation to trade shares and derivatives on regulated markets *Third-country trading venues may be considered as regulated markets for the purpose of these articles*	**No** .	**No equivalence decision has been adopted** **(**MiFIR and MIFID II enter into application in January 2018)
	Art. 33 MIFIR: Derivatives: trade execution and clearing obligations *Third-country trading venues can be accepted to fulfil the requirements for trade execution and clearing obligation on derivatives*	**No**	**No equivalence decision has been adopted** **(**MiFIR and MIFID II enter into application in January 2018)
	Art. 38 MIFIR: Access to the EU for third-country trading venues and CCPs *Third country trading venues and central counterparties ("CCPs") recognised under EMIR may be permitted access to EU CCPs and trading venues*	**Yes**	**No equivalence decision has been adopted** **(**MiFIR and MIFID II enter into application in January 2018)
	Art. 47 MIFIR: Investment firms providing investment services to	**Yes**	**No equivalence decision has been adopted**

	EU professional clients and eligible counterparties *Non-EU firms will be able to provide cross-border services from outside the EU to professional clients and eligible counterparties established in the EU.*		(MiFIR and MIFID II enter into application in January 2018)
	Art. 25(4) MIFID II: Assessment of suitability and appropriateness of clients *A third-country market can be assessed equivalent to a regulated market to appreciate whether financial institutions have to enquire about a person's knowledge and experience in the investment field.*	**No**	**No equivalence decision has been adopted** **(**MiFIR and MIFID II enter into application in January 2018)
Capital requirements directive and regulation (CRD IV/CRR) (No. 575/2013)	**Article 107(4) CRR Credit institutions /investment firms/ exchanges** *Allows institutions to treat exposures to third country investment firms, credit institutions and exchanges as exposures to similar EU financial institutions.*	**No**	For exposures to credit institutions: **Australia, Brazil, Canada, China, Guernsey, Hong Kong, India, the Isle of Man, Japan, Jersey, Mexico, the Principality of Monaco, Saudi Arabia, Switzerland, Singapore, South Africa** and **the USA. (2014)** For exposures to investment firms: **Australia, Brazil, Canada, China, Hong Kong, Indonesia, Japan (limited to Type I Financial Instruments Business Operators), Mexico, South Korea, Saudi Arabia, Singapore, South Africa, USA. (2016)** - For exposures to exchanges: **Australia, Brazil, Canada, China, India, Indonesia, Japan, Mexico, Saudi Arabia, Singapore, South Africa ,South Korea and the USA** **(2016)**

	Articles 114, 115, 116 CRR: Exposures to central governments, central banks, regional governments, local authorities and public sector entities *The specific risk weights applicable to exposures to central governments, central banks, regional governments, local authorities, and public sector entities may apply to similar entities located in third countries for the purpose of calculation of the capital ratio of EU financial institutions.*	**No**	Equivalence decision for all these third countries: **Australia, Brazil, Canada, China, Guernsey, Hong Kong, India, Isle of Man, Japan, Jersey, Mexico, Monaco, Saudi Arabia, Singapore, South Africa, Switzerland, USA (2014)**
	Article 142 CRR : credit institutions/ investment firms *A subsidiary located in a third-country can be taken into account for the definition of 'large financial sector entity'.*	**No**	Equivalence decision on credit institutions: **Australia, Brazil, Canada, China, Guernsey, Hong Kong, India, Isle of Man, Japan, Jersey, Mexico, Monaco, Saudi Arabia, Singapore, South Africa, Switzerland, USA. (2016)** Equivalence decision on investment firms: **Australia, Brazil, Canada, China, Hong Kong, Indonesia, Japan (limited to Type I Financial Instruments Business Operators), Mexico, South Korea, Saudi Arabia, Singapore, South Africa, USA. (2016)**
Solvency II: (No. 2009/138)	**Art. 172 Solvency II: equivalent treatment of third-country reinsurers** *Reinsurers from third-country can be recognised as equivalent as EU reinsures*	**Yes**	**-Bermuda (2016)** **-Japan (2015)** **-Switzerland (2015)**
	Art. 227 Solvency II: equivalence of third-country solvency rules *Third-countries solvency rules can be considered equivalent for the calculation of the consolidated capital requirements of EU*	**No**	**Australia, Brazil, Canada, Mexico and the United States (2015)** **- Switzerland (2015)** **- Bermuda (2016)** **-Japan (2016)**

	insurance groups present in third-countries.		
	Art. 260 Solvency II Parent undertaking outside the EU *The EU can recognise the equivalence of group supervision exercised by a third-country*	**No**	**-Bermuda (2016)** **-Switzerland (2015)**
European Markets Infrastructure Regulation (EMIR) **(No 648/2012)**	**Art. 1(6) EMIR Central bank** *Transactions with central banks from third-countries can be exempted from the scope of the regulation (in the same way as transactions with the European System of Central Banks)*	**No**	**-Japan (2013)** **-United States of America (2013)**
	Art. 2a EMIR Regulated markets: *Defines when a third-country market is considered equivalent to a regulated market.*	**No**	**- United States of America (2016)**
	Art. 13 EMIR Transaction requirements: *Third-country regimes can be considered as equivalent to avoid complicating or conflicting rules on financial transactions*	**No**	**No Equivalence Decision has been adopted**
	Art. 25(6) EMIR: CCPs *procedure for recognition of central counterparties ('CCPs') established in third countries* **Article 75 EMIR: Trade repositories** *Third-country trade repositories can be recognised equivalent to be able to conclude international agreements for the exchange of information on derivatives contracts*	**Yes**	**-Australia (2014)** **-Hong Kong (2014)** **-Japan (2014)** **-Singapore (2014)** **-Canada (2015)** **-Switzerland (2015)** **-South Africa (2015)** **-Mexico (2015)-Republic of Korea (2015)** **- USA (2016)** **No Equivalence Decision has been adopted**

Prospectus Directive (No. 2003/71)	**Art. 20(3): Equivalence of prospectuses** *Third-country issuers: third countries may be authorised to ensure the equivalence of prospectuses drawn up in that country with this Directive* **Art. 35 of Regulation 809/2004: 3rd country GAAP with IFRS:** *Foreign issuers listed in the EU will be allowed to continue preparing their accounts using their own accounting standards instead of having to restate their financial statements using IFRS.*	**No** **No**	**No Equivalence Decision has been adopted** **-Canada, China, (South) Korea (2012)** **-Japan, USA (2008)**
European Transparency Directive **(No. 2013/50, 2004/109)**	**Art. 23(4) Sub-para 3: 3rd country GAAP with IFRS:** *equivalence of accounting standards* **Art. 23(4): General transparency requirements:** *The third country where the issuer is registered ensures the equivalence of the information requirements provided for in this Directive*	**No** **No**	**- Canada, China, (South) Korea (2012)** **-Japan, USA (2008)** **No Equivalence Decision has been adopted**
Accounting Directive **(No. 2013/34)**	**Art. 46: country-by-country reporting:** *Equivalence of third-country reporting requirements*	**No**	**No Equivalence Decision has been adopted**
Credit Rating Agencies Regulation **(No. 1060/2009, 462/2013)**	**Article 5(6): Equivalence:** *Credit rating agencies authorised or registered in third country comply with legally binding requirements which are equivalent to the requirements of this Regulation*	**No**	**- Australia (2012)** **-Argentina (2014)** **-Brazil (2014)** **-Canada (2012)** **-Hong Kong (2014)** **-Japan(2010)** **-Mexico (2014)** **-Singapore (2014)** **-USA (2012)**
Statutory Audit Directive **(No. 2014/56, 2006/43)**	**Article 47(3): Adequacy of audit framework:** *Third countries may be recognised as adequate to cooperate with the competent authorities of Member States on the exchange of audit working papers or other documents held by statutory auditors and audit firms.*	**No**	Equivalence decision for all these third countries **Brazil, Dubai, Guernsey, Indonesia, Isle of Man, Jersey, Malaysia, South Africa, South Korea, Taiwan, Thailand (2016)**

			- Canada, Japan and Switzerland (2010) **- Australia and the USA (2010)**
	Equivalence of audit framework: **Art. 46(2)** *sets the framework for a possible reliance on a third-country oversight system in Europe, subject to reciprocity.*	**No**	**-Mauritius, New Zealand, Turkey (2016)** **-United States of America (2016)** **-Abu Dhabi, Brazil, Dubai International Financial Centre, Guernsey, Indonesia, Isle of Man, Jersey, Malaysia, Taiwan, Thailand (2013)** **-Australia, Canada, China, Japan, Korea, Singapore, Africa, Switzerland (2011)**
	Article 46 (2) Equivalence: transitional period *The Commission may decide that the requirement of equivalence referred to in paragraph 1 of this Article is not complied with, it may allow the third-country auditors and third-country audit entities concerned to continue their audit activities in accordance with the requirements of the relevant Member State during an appropriate transitional period.*	**No**	**-Bermuda, Cayman Islands, Egypt, Russia (2016)**
Regulation on Central Securities Depositories (CSDR) (No. 909/2014)	**Art. 25(9): CSDs:** *equivalent system for the recognition of CSDs authorised under third-country legal regimes.*	**No**	**No Equivalence Decision has been adopted**
Regulation on Transparency of Securities Financing Transactions (SFTR)	**Art. 2(4): Central bank exemption:** *Exemption of the monetary responsibilities of t third-country central banks and bodies*	**No**	**No Equivalence Decision has been adopted**
(No. 2015/2365)	**Art. 19: Trade repositories:** *Equivalence and recognition of trade repositories in Third countries*	**No**	**No Equivalence Decision has been adopted**

	Art. 21: Transaction requirements: *Equivalence of legal, supervisory and enforcement arrangements of a third country ensuring protection of professional secrecy*	**No**	**No Equivalence Decision has been adopted**
Benchmarks Regulation **(No. 2016/1011)**	**Art. 30 (2): Requirements for benchmark administrators:** *Administrators authorised or registered in third country can be recognized as equivalent to the requirements under this Regulation in order to be used in the Union* **Art. 30(3): Specific administrators or benchmarks:** *Third countries specific administrators or specific benchmarks or families of benchmarks can be recognized equivalent to the requirements under this Regulation, so they can be used in the Union*	**No** **No**	**No Equivalence Decision has been adopted** **No Equivalence Decision has been adopted**
Short Selling Regulation **(No. 236/2012)**	**Art. 17(2): Requirements for markets:** *The legal and supervisory framework of a third country market may be considered as equivalent so it can be exempted for market making activities and primary market operations*	**No**	**No Equivalence Decision has been adopted**
Market Abuse Regulation (MAR) **(No. 596/2014)**	**Art 6(5): Exemption for monetary and public debt management activities:** *This Regulation may not apply to to certain equivalent public bodies and central banks of third countries.* **Art. 6(6): Exemption for climate policy activities:** *This Regulation may not apply to to certain equivalent designated public bodies of third countries that have entered into an agreement with the Union pursuant to Article 25 of Directive 2003/87/EC*	**No** **No**	Equivalence Decision for all these countries **:** **Australia, Brazil Canada, China, Hong Kong, India, Japan, Mexico, Singapore, South Korea, Switzerland, Turkey, USA (2016)** **No Equivalence Decision has been adopted**